Combining Commerce and Culture: Establishing Business Relations in China

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Abstract	It seldom happens that new firms, new industries, and new business systems need to be developed simultaneously. This, however, is the situation in transition economies such as China. Irrespective of product and technology used, incentives and governance structures need to be formulated that give business endeavours an organisational form. The survivability of firms depends further on the ability to start and maintain long-term business relations between contracting parties, while only a broad consensus within the community of entrepreneurs and firms on the procedures that co-ordinate business relations and sanctions transgression promises a decline in transaction costs sufficiently enough to trigger off the quick expansion of markets.	
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Combining Commerce and Culture: Establishing Business Relations in China.

It seldom happens that new firms, new industries, and new business systems need to be developed simultaneously. This, however, is the situation in transition economies such as China. Irrespective of product and technology used, incentives and governance structures need to be formulated that give business endeavours an organisational form. The survivability of firms depends further on the ability to start and maintain long-term business relations between contracting parties, while only a broad consensus within the community of entrepreneurs and firms on the procedures that co-ordinate business relations and sanctions transgression promises a decline in transaction costs sufficiently enough to trigger off the quick expansion of markets.

Based on transaction cost, cross-cultural, and evolutionary theory, the present study attempts to explore to which extent Chinese entrepreneurs and the business sector react systematically – and in this sense rationally – to the situational problems of their environment, such as a high share of non-tradable input, institutional weakness, and uncertainty due to the fact that there is little experience of and memory with "what can go wrong" in doing business.

As institutions – in form of organisations and or norms – help to streamline behaviour, thus facilitating the formation of stable expectations about market reactions, response of business partners, or moral hazard, the empirical study further focused on how entrepreneurs and firms deal with the institutional vacuum in the new private sector. In general, the necessary institutional innovativeness can have two sources, the deliberate design of an institutional architecture that is expected to effectively support private exchange, such as the market, or private property rights legislation, or the "spontaneous" reviving of cultural norms and social institutions that are known to have worked in the past. Based on previous studies on cultural patterns, the study focuses also on the question in how far the long term-orientation, collectivism, and performance orientation influences the individual and collective choice when it comes to selecting business routines and sanctioning mechanisms.

The results show that to overcome the resource constraint is the single most crucial factor that drives entrepreneurship at the firm and the industry level. The ability to offer incentives for co-operation between individuals and government agencies in control of scarce resources is decisive for the establishment, operation, and expansion of firms. Subsequently, as this kind of social capital can appropriate a high rent entrepreneurship is driven by managerial skill rather than by technical innovation.

Chinese firms use newly introduced institutions such as the market, as well as traditional institutions such as trust or reputation. Although the database does not allow bold predictions the study suggests that the selection of private transactions supporting institutions shows two systematic features. An institution is chosen when it helps to overcome the resource constraint, including the managerial constraint and the ability to collect information about further business opportunities. An institution is also chosen when it helps to mitigate the "relational risk" between business partners in the sense that ambiguity is avoided and transgression sanctioned. The performance orientation found as a cultural pattern in China allows entrepreneurs combining culture-based institutions and the man-made architecture of a modern business system.

INTRODUCTION: CONSTRAINTS AND STRATEGIES

To define China as a culture or by its political regime misses the specific situation economic actors find themselves in after the reforms started in 1978. China as a transition economy is better defined by the set of economic problems that constrain individual behaviour and shape the emergence of a private business sector (Qian 2000; Nee 2000). The general assumption in what follows is that three factors describe the economic and political environment sufficiently enough to explain the observable behaviour of entrepreneurs and firms, individual and collective behaviour. These three factors are uncertainty, missing property rights, and a high share of non-tradable input (Krug and Polos 2000).

Based on the literature on entrepreneurship, business relations[2], and new trends in industrial ecology (Hannan and Freeman 1989; Carroll and Teece 1999), it is further assumed that these three factors, on the one hand, define a threshold for entrepreneurship, i.e. the costs of setting up a private firm; and on the other hand, they define the opportunity for firms and entrepreneurs to agree upon procedures and enforcement mechanisms that facilitate bilateral and multilateral transactions. Subsequently, the field study focused on two subsets of data, the foundation of firms as revealed in their oral history of the pre-sample period, and the ongoing operational activities of firms, as described through completing the questionnaire[3].

The two aspects of entrepreneurship are connected. It would be misleading to assume that the remnants of the socialist past create a threshold that when overcome leads ineluctably to the establishment of firms and a business sector following conventional (Western) patterns. The general assumption is that in both cases - i.e. the start up and the operations of firms - the outcome depends on

- Individual choice: the ability of economic actors to connect people with access to scarce resources and input needed for the establishment and operation of a firm;
- Interactive choice: the agreement of (at least) two partners to establish long-term exchange relations by designing and employing devices that allow ambiguity to be avoided while permitting the monitoring and enforcement of the relationship;
- Social choice: the consensus of a great many economic actors to certain modes of trade, as well as business practices and norms.

The last point needs further explanation: As the whole private sector is a new departure for the organisation of production and distribution in China the emerging markets remained underinstitutionalised. Due to the socialist past, lack of integration in the world market, and low general income level, private entrepreneurship in all transition economies is exposed to a liability of newness problem (Stinchcombe 1965) where technical, competitive, and process-uncertainty shape the dynamics and direction of entrepreneurship:

- First, there is no routine of business practice upon which an economic agent can rely. The changes in the society at large, which accompany the transition process, make it hard to locate expertise, agents or procedures, which can be imitated or copied. Neither can expertise be bought or learned with the help of formal or informal education.
- Second, there is no readily available “template” for success or failure as there is no collective memory about what may go wrong, and no past experience on which to rely.

- Third, there is no general knowledge about (excess) demand, price- or income elasticity of demand, let alone systematic research that would help entrepreneurs or industries to calculate the risk of a venture.

In such a situation two developments can be expected. One is the deliberate design of architecture for firms, such as company statutes, or around firms, such as legal institutions that guarantee property rights. Another development is culture; here understood as implicit codes and rules whose compliance is not enforced by collective agents, such as a government or a supervisory board, at the top of a well-established hierarchy. Instead compliance depends on individuals who voluntarily have subscribed to such codes and rules.

The relationship between architectured and culture-based institutions in transition economies is complex. The less architectured institutions exist, the more, by necessity does the emergence of firms and the coordination of business relations between the firms depend on remembered tradition, namely culture. As Coase (1937) pointed out more generally, the costs of using the nascent markets remain too high so that there are incentives to look for other institutions that might serve the same purpose, namely to allow private production, and the allocation of resources at lower costs. Culture in the case of transition economies is a valuable resource to the extent that it offers devices to overcome the problem of missing property rights, the non-tradability of input, and uncertainty. Cross-cultural studies (e.g. Hofstede 1991; 1993; House *et al.* 1999; Javidan and House 2001; Chinese Culture Connection 1987) identify the following patterns in China:

- First, the dimension of collectivism, by which it is meant that the Chinese identify more with collective small groups for which they feel affinity than with individual choice and achievement[4]. As recent studies show (House *et al.* 1999; Chinese Culture Connection 1987) the concept of collectivism needs to distinguish two forms.

- Second, the dimension of long-term orientation, which describes the extent to which societies encourage and reward future-oriented behaviours such as planning, investing in the future, and delaying gratification (Javidan and House 2001; Hofstede 1991; 1993).
- Third, the dimension of performance orientation (House *et al.* 1999; Javidan and House 2001) referring to the degree to which a society encourages and rewards group members for performance, improvement, and excellence.

These three dimensions form a set of “latent” behavioural codes. Whether and to what extent they will be mobilised and employed depends on the existence and acceptance of architectured institutions. Within this framework, the impact of culture, furthermore, can be expected to be greater the larger the pool of remembered cultural norms economic actors assume to be of value in the present situation; and the quicker a consensus can be reached by a large number of economic actors which of the remembered norms to select and adapt to the present situation so that positive externalities can be appropriated.

In short, cultural norms need to be remembered, employed, or even dismissed, if they should prove to be of limited value only. It is proposed that architectured institutions will crowd out culture-based institutions if they prove to be of higher functional value, and to the extent that they are regarded as compatible with cultural norms by a sufficiently large numbers of individual actors.

Based on this reasoning, the analysis highlights the importance of social capital to individual choice. In a situation of uncertainty, non-tradable input, and missing property rights, social capital is the single most crucial element in the initial endowment of a firm (Krug and Mehta 2002; Qian 2000; Krug and Hendrischke 2002).

Seen statically, social capital is seen as the ability to connect with those who control necessary input, in particular those who the individual entrepreneurs know well enough to predict their behaviour (Coleman 1986; Baker and Obstfeld 1999). Seen dynamically, social capital allows an entrepreneur or firm to join forces with others in order to generate (non-tradable) input, to design property rights and contractual security-offering "jurisdictions", as well as to form groups that can design and enforce transaction cost-saving behaviour. Both the ability to connect and the chance to find like-minded people who will "spontaneously" employ similar norms and devices result in business relations.

The study made use of two data sets. A series of open questions asked about the history of the firm, in particular to examine the entrepreneurial activities that preceded the start of production. If entrepreneurs needed to connect with other people in order to get the initial endowment together, then this should be reflected in "ownership", loans, or other long-term obligations toward the partners in the initial endeavour.

It was expected that the start up of private firms in China would prove to be the outcome of a collective effort, co-ordinated by one individual. If social capital is the most crucial component in the initial endowment, then it can be expected that private firms are started less by individuals who developed a new product, or a better technology for production or distribution, than by those who are assumed by their potential partners to be competent as a co-ordinator, and to be honest. Such competences can be seen as managerial skills to the effect that managerial skill defines a strong resource constraint on the establishment and development of firms. And indeed one of the striking results of the empirical study, as will be seen in what follows, is that entrepreneurship in China is driven by social capital and managerial skills rather then by product innovation.

INTERACTIVE CHOICE AND ENTREPRENEURSHIP

In order to ensure that the private sector does not get stuck in wheeling and dealing, arbitrage trade or spot market transactions, ways need to be found to establish long-term business relations between firms. The socialist legacy that in the past had explicitly forbidden private exchange makes such relations a costly affair. There is first the confiscation risk. As long as private property rights are not guaranteed any long-term investment carries a risk. There is secondly, the illegality of certain transactions. All those resources over which the state still claims exclusive control can be privately acquired only via a black market to the effect that private entrepreneurs become vulnerable, i.e. can be prosecuted, when greater openness should be regarded as useful. Third, any private deal whether legal or not, could not be enforced in a court of law at a suitably low cost until the end of the 1990s.

Economic theory would expect that business partners see the (economic) value in the use of contract. Contracts enable business partners to stay indifferent with respect to personal attributes of other actors, therefore facilitating anonymous transaction co-ordinated via the market, and thus resulting in exchange where differences in price, quality, technology, or co-operation gains steer resources to their most efficient use. Be that as it may such (neoclassical) mechanisms depend crucially on the existence of functioning markets, where market discipline and effective property rights legislation sanction moral hazard. The need to establish long-term business relations in an environment of non-functioning markets and poorly enforced private property rights, forces business partners to take opportunistic behaviour seriously.

The literature on economic custom (Greif 1993; Schlicht 1999; Krug 1999; 2002) indicates monitoring past behaviour is a useful device for predicting future behaviour. Those economic actors who have been known to be honest in the past, are regarded as the preferred group from which to choose business partners. Thus, in private business transactions both partners cannot afford to remain ignorant of personal attributes. Yet, only to the extent that supporting institutions will be developed which co-ordinate the sanctions after transgression, ensure solidarity, and facilitate the working of “reputation” will impersonal exchange emerge, which is crucial for the development of a private business sector (Greif 1993). As the China-specific (Eastman 1988; Freedman 1970; Wong 1985; Parris 1996) but also the management literature (Boisot and Child 1999; Redding 1996a; 1996b) assume, the natural institution for this activity is the (extended) family, or social institutions such as friendship or trust.

SOCIAL CHOICE AND ENTREPRENEURSHIP.

From psychology it is known that personal variables, such as traits, only show up in "weak" situations, i.e. those situations in which there are no strong behavioural norms, no strong incentives for specific types of behaviour, and no clear expectations as to what behaviours are rewarded and punished (Mischel 1973; Barrick and Mount 1993). Cultural norms as internalised norm sets and behavioural dispositions have become part of a person's identity and therefore can be treated as traits. On the other hand in "strong", highly structured (architectured) situations in which there is one best way, i.e., norms and behavioural options, of acting, people will show situational induced behaviour. Such strong situations create less opportunity to express inherent dispositional cultural tendencies. Countries with a well-functioning market economy and judicial system fit the description of a strong situation. In the economic domain of such countries strong behavioural expectations can be found towards the use of the existing and functioning architectural resource allocation and conflict resolution institutions, thus, limiting the need to develop culture-specific institutions. In the case of China as a transition economy, architectured institutions are missing to a large degree, thus providing the necessity for the Chinese business sector to employ cultural institutions and permitting Chinese entrepreneurs to show culture-specific behaviour.

The literature on Chinese norms subsequently suggests the following patterns in social choice situations:

(1) Chinese entrepreneurs will strive for collectivist problem resolution leading to the building of networks as loose social institutions enabling contact, co-operation in actions (Yeung and Tung 1996), sanctions for transgression in behaviour (Greif 1993). The psychological, cultural, and economic literature, all argue that for co-ordinating their network activities

(2) Chinese will rely on long-term social concepts like reciprocity, trust, honour, and reputation (Davies *et al.* 1995; Luo and Chen 1996; Park and Luo 2001; Krug and Polos 2000) in order to reduce risk and secure stricter business control (Kiong and Kee 1998).

(3) Taking Chinese high performance-orientation into account these approaches further assume the Chinese to have internalised economic reasoning as well.

Moreover, the combination of collectivism and performance orientation must have consequences for the way the Chinese assess networks.

(4) Networks will not be maintained irrespective of functional value. And indeed the literature on Oversea's Chinese communities and business groups has already argued for some time that for Chinese networking is a business activity in which cultural norms and economic reasoning are seen as mutually enforcing (Lever-Tracy 1996; Menkhoff 1992; Redding 1996b; Tsang 1998, Whitley 1990; Yeung 1994; Xin and Pearce 1996).

(5) Existing research on conflict resolution expects Chinese firms to look primarily for bilateral solutions in dispute settlement in the form either of negotiation or of relying on a trusted third person rather than depending on external institutions (e.g. Bond *et al.* 1992; Trubisky *et al.* 1991; Kirkbride *et al.* 1991). The "face-maintenance" hypothesis (e.g. Ting-Toomey and Kurogi 1998) argues that legal action, for example, is a procedure in which both parties are blameworthy (Xu 1994), loosing face, and disturbing the "harmony".

THE EMPIRICAL STUDY

Sample Selection

Two hundred interviews conducted during 1995-2001 form the background of what follows. While in the first few years only open interviews were executed, a standardised questionnaire was developed in 1999. Three provinces have been selected so far for the interviews, Shanxi in North China, Zhejiang and Jiangsu in the South[5].

Data sources

It was quickly learned that neither official classification systems, as found for example in the State Statistical Yearbooks, which clusters firms according to administrative units; nor self-identification through individual enterprise business cards provided meaningful, and certainly not consistent information about a firm. Subsequently, an economic definition was used in the sense that the calculation of net (residual) profit and the competition in the respective sector decided whether a firm was regarded as a private firm, or a socialist firm. The distribution of net profit allowed a better view of the ownership composition and its change during a firm's life history. We included those "joint" ventures in our study in which one individual state agency did not control more than thirty percent of capital, and as long as the management did not have to "report" to a superior state agency, or were forced to transfer all profit.

At the end, the data set included 104 "private" firms that met the requirements. The interviews explicitly separated two time periods. A pre-sample period concentrating on the life history of the respondent's firm; and the sample period concentrating on the description of the governance structure within and around the firm. While open questions were used to collect the life history, a standardised questionnaire was developed for to examine the governance structure and configuration around firms.

Data collection

While the partner universities in the three provinces arranged access to firms in China, we provided selection criteria to counterbalance a natural bias of our colleagues with respect to location, or personal connection[6]. Thus, the stratified sampling used size, location and sector as criteria by insisting that not only large but also middle scale firms, not only urban but also village firms, and not only firms working in traditional but also modern sectors which did not exist before the reforms started were visited. However, despite these efforts, networking played a necessary role. Private talks with academic collaborators suggest that the respondent firms were selected with the help of the following institutions: the Party, the academic network, banks in Shanxi, corporate networks in Zhejiang, and quite surprisingly, local tax bureaus in Jiangsu.

Data Analysis

As the main goal of the study was to get insights in the functioning of Chinese business relations the analysis rests on both cases from the life history of firms, and simple statistics. The open interviews followed the procedure known as Event-History-Designs (Carroll and Hannan 2000). The question focused on time, more precisely a sequence of events. The events referred to qualitative distinctions as defined in the conceptual set-up. Such events were the establishment of a company, i.e. those activities that preceded the registration of the firms or the beginning of production, changes in the ownership structure, expansion beyond the local nexus, diversification, or mergers. It is worth mentioning that our contribution is mainly exploratory, meaning that it is not intended to test existing theory. Instead, its primary purpose is to generate new insights, and hopefully stimulate further research.

INDIVIDUAL CHOICE: THE GENERAL CHARACTERISTICS OF FIRMS

If the foundation of firms depends on social capital that allows pooling of necessary non-tradable physical, financial and human capital then, it is to be expected that the initial ownership structure reflects that collective effort. Indeed, only 25.4 per cent of the firms visited was owned by one person, usually the respondent, alone, 74.6 per cent were owned by a collective.

The figures also point to one of the most striking results of the study: With only 12.7 per cent of the firms being owned by the respondent's family the original assumption that the family will be the single most important institution best suited for co-ordinating the collective effort that precedes the establishment of a firm did not survive empirical scrutiny. This point is supported by the following findings:

First, the family did not provide the assets for starting a firm: Only 27.1 per cent of the respondents answered that their family was a source of funds for capital assets when the firm was first set up whereas 72.9 per cent denied this statement.

Second, the family was not assumed to function as a risk-mitigating institution on which one could fall back in time of need. One single entrepreneur stated to expect that his family would come to his help in the event of a serious problem or emergency, merely 16.2 per cent relied on help of their friends. On the other hand, 52.9 per cent showed confidence in being helped by banks indicating that capitalistic mechanisms seem to have replaced old family bonds.

Third, the family was not regarded as a means for accumulating social capital. This is reflected by the fact that family connections are significantly less considered to be crucial for the success of the firm than economic factors or social institutions like mutual trust between business partners (see below and Tab. 2).

A look at the life history of firms further revealed that age and expansion of a firm actually led to a further decline of family ownership and control. On one side, family firms remain in the traditional small scale retail trade, or service sector only. On the other side, managers of expanding firms often enough found it appropriate to incorporate their firm. One device of doing so was to ask family members to stand in for the at least two share-holders a corporation needs according to company law. The reason given for this procedure was often that by asking a family member to let him/herself register as partner the manager made sure that he could keep complete control over the operational side of the business. In other cases managers argued that by limiting the family members' stake to registered capital he could make sure that the family would not be able to demand managerial positions. This result is certainly in sharp contrast to the assumption that in China the collective interest of the family would be stronger than any economic rationality (see also Pistrui *et al.* 2001).

The life histories of firms demonstrate that privatisation in China is dominated by the transfer of control rights from local authorities to a manager, i.e. somebody who could credibly promise to turn the local industrial assets into profitable companies. In sometimes ingenious ways these managers once proven to be successful were offered 'management-buy-out' schemes. While some took complete control, the majority preferred a corporate solution[7]. The village, local government, or other state institutions were offered minority shares. By doing so the managers wanted to ensure future benign treatment of these agencies in form of favourable taxation, complementary infrastructure around the production site, or access to the information network available within the state bureaucracy. Another strong reason for accepting state agencies as shareholders was that by this means the unspecified claims on residual profit could be converted into shares to be compensated by dividends. In short, the corporatisation of firms was one step closer to full private property rights and toward the specified entitlements and liabilities of the new organisational form.

Case 1: Management Buy Outs

The general manager laid the foundations for Pump Factory Ltd. in 1976 when at the age of 18 he started work at a small repair workshop for water pumps in his village. In 1983 he headed a small collective enterprise, which by that time had nine workers producing spare parts for pumps, with an annual turn over of several thousand *yuan*. The small collective entered a boom period when local household farms began investing in small individual water pumps to replace the large village-owned pumps. Demand for these locally produced pumps was so strong that the workshop kept increasing production even during the recession of the years after 1989. Eventually, the village administration decided to liquidate its ownership rights in the highly profitable firm.

In 1994, in preparation for incorporation under the Company Law, the asset value of the enterprise was estimated at 20 million *yuan* and shares for this amount were offered to the workforce. The general manager originally intended to acquire a 51 per cent majority, but for political reasons had to settle for a 49 per cent share. He was required to make cash payment of 2 million *yuan* to the village. The rest he was allowed to pay in installments from his expected future profit share. His deputy paid 500,000 *yuan* and a further six managers 800,000 *yuan* together for smaller individual shares. The remaining shares were given to the workers and employees of the enterprise. In theory, these shares were transferable. Yet, as other interviews indicate, they were linked to the jobs and could even serve as a means to keep demands for pay rises at bay. The local government invested the proceeds from this buy-out in a new building to serve as an administrative and market center for their river pearl business, a cement plant and village infrastructure.
Since 2000 political restrictions on maximum individual shares have been lifted. The next planned step in the development of the enterprise is to list the company on the share market, without however, intending to float the manager's share.

The points to note in case 1 (from Krug and Hendrischke 2002) are that one entrepreneurial manager together with seven colleagues pooled savings to buy a majority share from a village whose leadership was obviously more than willing to give up control of their "collective" assets. The trust in the managerial skill of the buyers and the general prospect of the firm was enough to allow the manager to claim forty-nine per cent of ownership shares for ten per cent of the registered capital. Even if his and his colleagues' down payment can be interpreted as a collateral that enforces their commitment, the generous "buying-in" deal offered to him can also be seen as a rent that scarce managerial talent can demand and appropriate in the current economic environment.

The major role friends and colleagues play in both the starting of a business and in the ongoing operation points to an interpretation as to why the family as an economic actor has moved to the margin. If friends and colleagues employ the same norms of reciprocity, mutual obligations, and promise, at a similar trust-level to the family, then friends, more numerous and less geographically concentrated, offer access to a broader resource base (and customers). In short, the disappearance of the family would then be the result of the small resource base over which the contemporary family has command. The alternative is a series of social groups that allow trading and co-operation at similar low transaction costs, but with broader resource bases, in particular with respect to human resources. Indeed, skilled labour and managerial skill were seen as the bottlenecks for the firms as the following shows (Tab. 1). T-tests revealed that these results were significant at a level of $p<0.05$: Respondents perceived the adequacy of skilled labour and of managerial skills significantly lower than those of all resources.

Insert Tab. 1

The interviews further showed that two groups of friends were particularly important: Friends and colleagues known from college or university, and friends from the military service in the Army. It is not hard to see that both groups offer a more favourable geographical spread and a broader resource base for the required human resources.

To sum up, the data suggest the following findings:

(1) The family is defined as the core family and therefore seen as an inadequate institution for establishing and operating a business.

(2) The dominant ownership and organisational form of firms is a corporation – registered or not yet registered – owned by a manager and friends plus state agencies usually from the same locality.

(3) To incorporate a firm is seen as an effective strategy to strengthen private property rights, to turn political stakeholders into shareholders, to clarify entitlements and liability, and to create the organisational identity (and prestige) for a business venture.

(4) The life path of firms is characterised by a change in ownership and organisational form. The "manager-turned-owner" (in contrast to the owner-turned manager who features in Western firms) dominates the privatisation of industrial assets formerly controlled by the state. Successful managers and not the classical Schumpeterian entrepreneur are offered a high premium for their skill in the present business system (as Case 1 showed).

INTERACTIVE CHOICE: TRUST AND MISTRUST

Following Greif (1993) it has already been argued that first, the selection of trustworthy business partners works as an effective ex ante device in an environment of ill-functioning markets and poorly developed legal institutions; and second, social institutions need to be employed that as a collective agent co-ordinate the sanctioning of opportunistic behaviour, or provide the necessary norms (of honesty) to which business partners commit themselves. In the case of China it was assumed that business partners would revive traditional institutions, such as the family or the village to serve such purposes. A third social institution that plays a major role in the discussion of Chinese business behaviour are the networks of special personal relationships built on friendship, affinity, and shared systems of norms (*guanxi*).

Such claims find support in studies of culture that point to the importance of collectivism, suggesting that social institutions are important tools for co-ordinating business relations. Surprisingly though, neither family connections nor friendship or existing relations played any role in the choice to enter into a business relation or in keeping up business relations (see Tab. 2). Comparing the perceived importance of family and personal connections with the mean scores of other factors considered to play a role in choosing and maintaining business relations shows that family and personal connections score significantly lower.

Indeed, the reasons given by respondents for choosing to enter into a business relationship show the following pattern:

Insert Tab. 2

Entrepreneurs seem to be mainly motivated by economic factors while surprisingly, social factors do not seem to play an important role in choosing a business partner. Paired samples t-tests could show that all differences between economic and social factors are highly significant at a level of $p<0.00$.

If, as already argued, cultural institutions are mainly employed or revived when and as long as architectured institutions are missing, then the findings can be interpreted as follows: Apparently after twenty years of developing a private business sector the market mechanism seems to work effectively enough to allow suitable business partners to be chosen according to economic criteria, such as price, quality, technology, or co-operation rent, therefore making culture-based mechanisms obsolete. To put it differently, so far the results would suggest the close link between the expansion of markets and the use of the narrowly defined (neoclassical) economic calculus.

Yet, it has also been argued, that cultural and economic reasons would lead to the employment of other social mechanisms such as trust, honour, and reputation. And indeed, the picture looks different when the question is put about why firms abide by agreements with their business partners (Tab. 2).

The answers show that reputation, honour, and (to a lesser degree) the long-term business orientation make Chinese entrepreneurs abide by their business agreements, rather than the fear of legal sanctioning. The average fear of legal redress is significantly lower than all other given reasons (results of t-tests were all significant at a level of $p<0.05$).

That opportunistic behaviour, sunk costs, or asymmetric information severely hamper the functioning of the markets as a means to enforce contracts, is known well enough. After all it was exactly for this reason that liability and property rights law became an essential part of (Western) business systems. This situation suggests that in China the link between supporting legislation and market sanctioning has not (yet) occurred, or that the Chinese do not trust their new law enforcement agencies. Both interpretations are reflected in the answers given. Only 43.3% of the respondents assumed written business agreements to be legally binding (see also Cheng and Rosett 1991); only 23.5% stated they had confidence in the national law to safeguard their firm's interests; and only 19.8% perceived a change in the legal system, or supporting agents such as lawyers' firms, during the last five years would help to resolve business disputes and support business relations. In other words, the architectured institutions are regarded as “alien” or useless. In such a situation, it was expected that cultural institutions would be employed. Indeed, as Tab. 2 shows, the concepts of honour and reputation representing the specific Chinese cultural patterns of collectivism and long-term orientation, work as substitutes for the judicial system.

These findings get additional support from the answers to a question about the necessary requirement for business success (see Tab. 2). The response to this question shows that Chinese entrepreneurs regard both economic ('prompt delivery and payment') and social factors ('mutual co-operation' and 'mutual trust') crucial for keeping a successful business relationship; t-tests found no significant differences between these factors whereas both proved to be considered as significantly more important than family connections and personal contacts. Once more the results confirm the assumption of a collectivistic, performance and long-term orientation in Chinese business behaviour.

Interestingly the social regulation mechanisms of honour and reputation are highly correlated with each other and with the factors that respondents claimed to be crucial for the success of a business relationship. Correlation coefficients (Spearman's rho) between these variables ranged from 0.3 to 0.66 and were all highly significant at a level $p<0.05$. It is tempting to interpret therefore the combination of honour and reputation as crucial in successful business relations.

To sum up:

(1) In contrast to expectations, the selection of suitable business partners does not follow criteria such as honesty or affinity. Instead “hard” economic factors such as prices, quality, or technology are decisive for private transactions, even in spot market transactions where the risk of opportunistic behaviour is lowest.

Apparently the respondents assume the market to function sufficiently enough to dismiss relational risk (Nooteboom 1996; Nooteboom *et al.* 1997), and to concentrate on products instead.

(2) The use of contracts is a poor indicator of the acceptance of the (new) legal system. Written contracts can reflect many things from compliance with the law to the avoidance of ambiguity in long-term business relationships, as further talks with Chinese colleagues and respondents demonstrated. The use of contracts, however, is not seen as a way to better enforce the liability of the business partners involved – as the general transaction cost literature claims (e.g. Williamson 1994).

(3) In order to ensure contract compliance, and to co-ordinate the sanctioning of opportunistic behaviour, Chinese firms revive and invest in social institutions such as reputation and "unspecified" networks that generate mutual trust and co-operation. These networks might have started as systems of shared values or joint local identity, such as the family or the village. In order to overcome their narrow resource base (and to survive in the long run) these networks need to expand beyond their original socio-demographic factors. This is illustrated by Case 2.

(4) All in all, the findings indicate that Chinese business practices can best be characterised by a mixture of social commitment and the use of an economic calculus.

Case 2: Networking[8]

Mr B is a graduate of Shanghai University. In 1992, he opened a small restaurant with personal savings of 10,000 *yuan* (about US-$800) enabling him to save a further 100,000 *yuan* with which he opened a larger restaurant. The mid-1990s saw an increase in the level of uncertainty in the sector and so he diverted his resources into the production of industrial coal and pig-iron when he saw an opportunity for entry into this erstwhile state-monopolised sector. His brother helped with a loan. The brother had already formed a private firm offering taxation services, and "he transferred his business networks and debts" to Mr B's firm. All loans and debts incurred via the brother were rapidly repaid from profits. Mr B observes that his major problem with expansion has been gaining access to capital funds at the right time. Mr B now has 250 employees the majority of whom are picked up as excess labour from the state-controlled sector. Employees receive generous wages as a reward to good performance, but also in bad times "to encourage them". He particularly values their willingness to alert him to investment opportunities.

Business deals are supported by verbal agreements. Mr B observes that monitoring is easy because most products are standardised, but that mutual trust, cooperation, and flexibility, together with personal reputation and honesty, are vital to success.

Mr B's relationships with firms and individuals in the state sector are vital to his success since he is dependent on them for access to resources and for market entry; for their part, the state-owned enterprises must barter for Mr B's products due to lack of cash. He is also dependent on good relations with township governments, village heads, and villagers in the areas where his factories are located since otherwise "they will cause trouble" over land use and transport issues. Mr B's relationship with his brother was essential when he first began as an entrepreneur because he was deemed to be an outsider as a result of his period in Shanghai; this connection is less important "now that I have established my own networks". Township and village enterprises are important customers; these are linked into a network and, since it is the network with which he conducts business, personal reputation and "connectedness" within this network are vital to success.

SOCIAL CHOICE: CONFLICT RESOLUTION IN BUSINESS RELATIONS

If in bilateral relations enough firms take recourse to social institutions then it can be expected that in general culture-based mechanisms will be developed that regulate conflict resolution in economic life. As already argued Chinese firms will employ such institutions in disputes that permit them to "keep face" and to "save harmony" (e.g. Kirkbride *et al*. 1991; Ting-Toomey *et al.* 1991; Xu 1994).

To abandon a business relationship, i.e. one of the most commonly used forms of economic sanctioning, necessarily leads to a loss of face for one of the partners involved. To go to court, on the other hand, easily harms the reputation of both parties when doing so indicates that both partners were not able to deal with the conflict in a "face-keeping" way. The results in Tab. 3 support this line of argument: While 31.6 per cent of the respondents stated to use economic sanctions (i.e., abandon the relationship), only 10.5 per cent would actually rely on court orders. To re-negotiate terms of contracts or compensation is seen as the natural way to settle disputes with or without the help of a jointly agreed upon arbitrator, 58 per cent of the respondents tried to reach such "social" solutions of disputes with a business partner.

Insert Table 3

On the other hand, law enforcement agencies are not seen as being completely without use. As the above mentioned finding that only 10.5 per cent of firms would redress to the court also shows courts were regarded as enforcement agencies "of last resort", and a convenient means to force the partner to re-negotiate contracts, and to accept the private orders of external arbitrators.

Interestingly enough, the interviews showed that subjects had problems with this question concerning the term 'irreconcilable' which they did not seem to understand or accept. Asked for a sequence of actions in such disputes 30.3% of the respondents answered they would first renegotiate with their business partner even though the dispute might be defined as irreconcilable, and that this possibility was not mentioned in the questionnaire (Tab. 3). Such behaviour is consistent with prior findings that Chinese continue negotiations longer than is common and in cases in which Western firms would let negotiation collapse (e.g. Kirkbride *et al.* 1991).

In short, the behaviour of Chinese business partners in resolving business disputes seems to be influenced by the same (cultural) norms of collectivism, long-term orientation and persistence, harmony, and face-maintenance already found in studies in other contexts.

To sum up:

(1) At this stage, law and law enforcement do not play a major role in business conflicts. If at all they are turned to as a last resort.

(2) One might cautiously speculate that the private sector will develop institutions for private regulation by which social institutions start to formulate common law. The use of social institutions in private regulation and the use of courts are not mutually exclusive, if these institutions get codified in the procedural law. In that case cultural institutions would become part of the new architectured system of institutions.

(3) Ruthless economic sanctioning, i.e. the use of the exit option, on the other hand, is also not seen as an effective means for enforcing contracts or obligations. An economic interpretation would point to the newness of and the uncertainty within the private sector where the need to keep contracts open and re-negotiable is much stronger than in well-established markets and sectors. Such an analysis can however not predict which institutions will step in. It is at this point that theorizing on cultural patterns proves fruitful. As already shown the long-term

orientation, and the need to search for "face-keeping" devices prompts the private sector to make use of these social institutions.

CONCLUSION

Chinese entrepreneurship reveals some specific features that can be explained by

- first, the situational constraint, such as non-tradability of resources, uncertainty, and weak private property rights, and
- second, by the individual and collective search for institutions that allow co-ordinating actions in the new private business sector.

At present the business system offers a high premium to social capital and managerial skills while abstract norms such as trust and reputation, facilitate the diversification of risk amongst several "investors" (and by doing so to function as a surrogate for the ill-functioning capital market).

Instead of trying to safeguard the once chosen organisational form, firms in China change their organisational form in response to changes in the business environment. The business environment is also not a given but characterised by the collective effort to select and agree upon institutions which are expected to facilitate the establishment of long-term business relations.

Employing the findings of transaction cost theory and cross-cultural studies shows that entrepreneurs and firms combine newly architectured, such as the market or the law, and old social institutions, such as trust. At first sight the use of these institutions does not seem to follow a systematic pattern. For example, on one side the Corporate Law is seen as an effective tool for establishing private property rights. On the other side the Contract Law is seen as an inefficient way for enforcing contracts. Likewise, the market is regarded as functioning well enough to allow selecting business partners by judging their products and prices only. The market is seen as inferior however, when it comes to enforcing business relations. While in each case an economic explanation can be found, the underlying trend is the same, namely that business partners do not blindly imitate their inherited institutions or the newly architectured ones, but carefully weight which institutional arrangement might be better suited.

Thus for example, when it became obvious that the resource constraint severely hampered the prospect of family firms, entrepreneurs quickly switched to another form that offered a broader resource base while still relying upon the same social institutions, in particular trust.

So far the results suggest that it might be the cultural pattern of long-term and performance orientation, which allows Chinese entrepreneurship combining (old) social with new architectured institutions without seeing them as mutually exclusive. Entrepreneurs and firms will select the institution best suited to overcome the resource constraint, and best suited for the co-ordination of transactions in the private business sector.

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Table 1: Perceived importance and adequacy of different resources

Resource	**important**		**adequate**	
	Frequency	Percent	Frequency	Percent
Transport	55	83.3	58	89.2
Air transport	22	36.7	50	87.7
Communication	60	89.6	64	95.5
Land	52	82.5	47	74.6
Unskilled labour	14	23.0	55	94.8
Skilled labour	64	97.0	37	56.1
Managerial skill	67	100.0	27	40.3
Raw material	46	80.7	48	84.2
Water and energy	54	83.1	59	89.4
Financial services	59	93.7	48	75.0
Local supplier	30	66.7	36	81.8

Tab. 2: Importance of economic and social factors for business relations

Variables	Mean	Standard Deviation	n
Factors important for firms in choosing to enter into a business relation			
Price	1.6	0.66	55
Quality	1.2	0.42	45
Reliability	1.4	0.57	58
Personal recommendation	2.2	0.79	62
Family connection	2.88	0.45	42
Pre-existing contacts	2.5	0.62	61
Reasons for abiding by agreements			
Threat of legal redress	4.9	2.0	36
Firm's reputation	6.1	1.1	36
Personal reputation	6.1	0.9	36
Honour	5.7	1.5	36
Friendship	4.5	1.2	36
Family connection	2.5	1.5	36
Need for future business	5.6	1.2	36
Requirements for the success of a business relation			
Mutual co-operation	6.2	0.7	36
Mutual trust	6.3	0.7	36
Prompt delivery and payment	6.1	1.2	36
Family connections	2.5	1.7	36
Personal contact	4.6	1.5	36

Scale for first variable ranges from 1='very important' to 3='not important'

Scales for other two variables range from 1='strongly disagree' to 7='strongly agree'

Tab. 3: Ways of dispute settlement

Variables	**Frequency**	**Percent**
Solutions for irreconcilable disputes		
(1) Recourse to the law court	4	10.5
(2) Social solutions	22	58.0
Private ordering	9	23.7
Help from a local community representative	1	2.6
External arbitrator	12	31.6
(3) Economic solution: abandon the relationship	12	31.6
Sequence of action in a dispute		
(1) immediate recourse to the law	1	3.0
(2) single social solution	7	21.2
(2) – (2) sequence of social solutions	10	30.3
(2) – (2) – (1) sequence of different social solutions followed by recourse to the law court)	2	6.1
(2) – (3) social solution followed by economic sanctioning	5	15.2
(2) – (1) – (3) social solution followed by recourse to law and economic sanctioning	2	6.1
(3) immediate economic sanctioning	5	15.2
(3) – (2) economic sanctioning in combination with social solutions	1	3.0

ENDNOTES

[2] After all business relations are the raison d'etre for the existence of firms (Coase 1937), other organisational forms for forming business relations can be found in Greif (1993).

[3] The methodological problems of such a procedure are discussed in Carroll and Hannan (2000).

[4] As recent studies show (House *et al.* 1999; Chinese Culture Connection 1987) the concept of collectivism needs to distinguish two forms. While the Chinese take especially pride in membership of small groups, such as villages or families, to which they develop great loyalty and cohesiveness; the Japanese for their part developed a stronger form of societal collectivism which makes them accept the collective distribution of resources and collective action (House *et al.* 2001; Javidan and House 2001).

[5] A description of Shanxi can be found in Goodman (1999). A description of the reforms in Zhejiang can be found in Krug and Hendrischke (2002). For a description of Jiangsu see Jacobs (1999) and Forster (1997).

[6] The selection criteria were developed collectively by J. Mehta, David S. G. Goodman, H. Hendrischke and the first author.

[7] The different features of this development can be found in Ding (2000), Hendrischke (2002), Krug (1997), Lin and Tian (2001), Nee (2000), Oi and Walder (1999), Rozelle and Li (1998), Rozelle, Park, Huang and Xin (2000), Wank (1995), Wank (1996), Yang (1989), Smyth (1997).

[8] The case is from the Shanxi file in 1999.

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