

Entrepreneurship in Transition: Searching for governance in China's new private sector

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Abstract	<p>Entrepreneurial activities in transition economies go beyond (technical) entrepreneurship. In an environment of institutional and procedural uncertainty entrepreneurs need to select business partners, choose a mode of governance that stabilizes long term business relations, and settle for such property rights regime that best matches the entrepreneurial endeavour. Based on fieldwork in China the paper shows how entrepreneurs combine their predisposition for social relations with economic reasoning when they embed firms in one location, in mixed forms of relational and contractual governance, and specific ownership structures. The empirical research points to alternative economic concepts which allow further analysing the interaction between individual entrepreneurship and the emergence of market conforming institutions.</p>	
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Entrepreneurship in Transition: Searching for governance in China's new private sector.

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INTRODUCTION*

Why has China produced higher growth rates than any other transition economy or let's say India, and this despite the lack of a coherent reform plan?

In general, ever since Coase (1937) and North (1989, 1990) it is assumed that property rights regimes can explain differences in economic performance of economies (or firms) with otherwise compatible resource endowments. According to this view, ill-defined property rights and weak enforcement can explain inefficient allocation of resources in a systematic way (Williamson 1975, 1986, 1996; Barzel 1989; De Alessi 1980; Furubotn and Richter 1997). Subsequently when socialism collapsed there seemed to be a solution at hand. All that was needed for a successful transition to a market economy was to get private property rights established and enforced while allowing the price mechanism to allocate resources (Sachs and Woo 1997; Shleifer 1998; Shleifer and Vishny 1994, Bull and Ingham 1998). Competition would force economic agents to search for efficient solutions, Competition would also stimulate the generation of intermediate institutions (so-called hybrids) that facilitate direct exchange in the presence of high transaction costs. Hindsight showed how difficult it is to transplant an efficiently working property rights regime into another society. For the establishment of property rights and the generation of market conforming institutions, the cultural and institutional setting of a society obviously plays a big role.

The case of China is instructive, as here an outright change of the property rights regime was not part of its reform policy. Nevertheless, China easily outperformed most, if not all, European transition economies that had followed economic advice and started their reforms by introducing private property rights and by liberalizing markets. Consequently, a literature appeared which implicitly if not explicitly argues that Chinese culture offers competitive advantages that compensate for the institutional disadvantage implied in the lack of a property rights regime (Wank 1996; Xin/Pearce 1996; Rozman 2002; Redding 1996b; Park/Luo 2001; King 1985; Hofstede 2001; Hamilton/Biggart 1988; Hamilton 1996; Boisot/Child 1996, 1998; Bian 1997). In the most general term, these cultural advantages can be summarised under *generic social*

capital and have led to the claim that there was an East Asian development model (Unger and Chan 1995). Generic social capital refers to a traditional predisposition toward relying on social relations that in China was not even interrupted during the planned economy period. A short summary of the views on this kind of social capital, usually referred to as *guanxi*, would look as follows:

- (1) Chinese economic agents tend to search for collectivist ways to solve problems. They habitually form networks as loose social institutions that facilitate contact and co-operation (Yeung and Tung 1996) and define sanctions for transgression in behaviour. Thus, private firms and networks *co-evolve*.
- (2) By doing so Chinese entrepreneurs rely on long-term social concepts like reciprocity, trust, honour, and reputation (Davies *et al.* 1995; Luo and Chen 1996; Park and Luo 2001) in order to reduce risk and secure stricter business control (Kiong and Kee 1998). Thus, the governance in and around firms will follow social norms.
- (3) Social norms, moral obligations pre-empt opportunistic behaviour. For enforcing co-operation or business agreements, Chinese economic agents primarily look for bilateral solutions in form of re-negotiation or make use of trusted third persons. External institutions, such as courts or “markets”(e.g. Bond *et al.* 1992; Trubisky *et al.* 1991; Kirkbride *et al.* 1991) are rarely used. Moreover, the “face-maintenance” hypothesis (e.g. Ting-Toomey and Kurogi 1998) argues that legal action can make both parties blameworthy (Xu 1994) because they lose face for disturbing social harmony. Harmony is preserved when economic agents generate “contractual security” through informal institutions such as trust or reputation.

Any attempt to endogenise social capital means would involve so many different aspects that no clear theoretical explanation for a superiority in Chinese economic performance would emerge. Theory-building in this case requires identifying each of these aspects, such as networks, trust, reciprocity, face etc. by a quantifiable dimension which can be tested in form of systematic correlations between dimensions and, finally, economic performance. This paper explores what dimensions for explaining economic performance can be singled out in addition to and beyond the property rights regime. Next, it explores if these dimensions can be operationalised (or quantified) and what parameters could be used in different economies in order to produce statistical evidence needed for theory building.

The starting point of the research is the (empirical) truism that the move from a socialist to a market economy depends on the emergence of entrepreneurs. In a private economy, entrepreneurs as economic agents find the institutions that enable them to turn innovations into new products or production techniques in return for becoming residual claimants of profit. How to mobilize entrepreneurship is a general research question for transition economies. In China, social relations are a contributing factor to institutional change and play a part in the mobilisations of entrepreneurship. However, economic reforms bring with them an initial break-up and transformation of social relations. Social structures that were formed under the planned economy need to be adapted in order to open the way for a market-based rationality and *economic calculus* to enter social relations. As a result, in the transition process new social relations emerge in response to new business opportunities. These new social relations ultimately need to conform to the market; they develop dynamically by utilising and at the same time discarding existing social structures.

To explain this development constitutes a challenge for transaction cost economics, evolutionary economics, New Institutional Economics, but also for the management science literature. Rather than using concepts developed for any of these theories and searching for empirical support, the research design used here followed a different path by turning to the entrepreneurs of the ever-growing number of new, i.e. non-state firms. These private entrepreneurs are the economic agents on whose perception, choice, or decisions China's economic performance ultimately depends. No claim is made that they "know" the reasons behind the overall performance of China's private sector, let alone understand the underlying systematic factors. What counts is which factors they regard as crucial for establishing private firms and for building up long-term business relations. This is the first step in singling out institutions or cultural components that might have contributed to the overall performance.

The paper proceeds as follows. Next, a short summary of previous studies on firms interacting as core economic organisations with their external economic and institutional environment (Sec. 2). The research design will be described in Sec. 3. A general description of the fieldwork and methods used follows in Sec. 4. Results will be presented in Sec. 5 around two main entrepreneurial activities, namely "How to establish a firm in an environment of high process-uncertainty and missing private property rights" and "How to establish long-term business

activities in an environment of missing contractual safety?”. Each part ends with a discussion of the empirical results in reference to the two dominant streams of literature on China’s economic performance. The paper concludes with some general remarks and desiderata for further research that could contribute to theory building.

PREVIOUS STUDIES

Overall, TCE finds it hard to transfer its insights to transition economies. The reason is that all different organisational forms or governance structures identified by TCE represent transaction specific responses within market environments, i.e. under voluntary exchange, private property rights and functioning price mechanism (Menard 2002).

However, TCE arguments are used in empirical studies to explain the emergence and functioning of firms and other intermediate governance institutions in China. These studies offer descriptive analysis based on field research in different locations and sectors and provide first insights into business practices in China. They agree that Chinese firms act efficiently when they search for modes of governance that reduce transaction costs. Transaction costs identified in these empirical studies are predominantly generated by administrative and political interference. However, the radical neoclassical view that China’s private sector would be better off if the state withdrew from the economic sector is hardly ever put forward in empirical studies. Instead, the challenge seems to lie in explaining why China’s economy is performing so well despite the lack of private property rights. As opposed to the “grabbing hand” (of the state) hypothesis (Shleifer and Vishny 1998), the alternative “helping hand” hypothesis draws attention to the supportive, transaction costs reducing role of the state as

- 1) fiscal decentralisation and jurisdictional competition were introduced (Wong 1992; Krug 2002),
- 2) local authorities offered access to non-tradable input such as material, land, loans and information, and
- 3) local authorities as regulators guaranteed property rights and contractual security (Walder 1995, Che and Qian 1998, Krug and Hendrichske 2003, Rozelle and Li 1998).

Research from a political economy angle shows that the transition process depends less and less on formal positions in the nomenclatura or the influence of political agents but on the discretionary power of local administrations to allocate resources and re-allocate entitlements and (ownership) rights (Guthrie 1999) within firms (Opper *et.al.*2002) and within markets (Nee 1992; Nee and Peng 1994). Nevertheless, there is a 'persistence' of old institutions and state bureaucracies which can be shown to benefit from the weak institutional frame of the reforms and the co-existence of the state sector and a nascent market sector by exploiting rent-seeking opportunities (Oi 1989; Shirk 1989; Stark 1990; Yang 2002). But even without market forces prevailing, there is agreement on the 'phasing-out' hypothesis" which claims that the discretionary power of the state bureaucracy is diminishing over time. The 'phasing-out' hypothesis rests on

- 1) fiscal decentralisation and jurisdictional competition which considerably limit the resources under state control (Wong 1992; Krug 2002; Montinola, Y.Y. Qian and B.R. Weingast 1995; Qian and Weingast 1997),
- 2) ownership diversification and experiments with different modes of governance combined with the need to make best use of resources under gradually strengthening property rights (Cao and Nee 1998; Qian 2000). This will lead to
- 3) a better performance of the new private sector which offers income and wealth creating opportunities outside the state sector (Nee 1992; Krug and Polos 2004). The resulting selection process attracts the more entrepreneurially minded (or better educated) economic agents to the private sector.

The state bureaucracy will be left with the power to redistribute rather than directly controlling resources (Nee 1989; 1992; Pearson 1997). Many of these studies rely on interviews with state firms and official statistics as illustrative evidence for explaining the changes in the organisation of firms, their interaction with the nascent markets and political authorities, or changes in transaction costs.

Approaches from social sciences which do not use transaction cost argument concentrate on the political and social consequences of the reforms. Political science approaches use the concept of local state corporatism to contextualise and downplay the importance of property rights as a crucial factor for explaining China's economic development (Unger and Chan 1995).

They point to the fact that China's first wave of economic growth was produced by (local) state controlled firms, when township and village enterprises (TVEs) in the mid-nineties accounted for half of China's industrial output value and nearly half of China's exports (SSYB 1997). The 'local state corporatism hypothesis' argues that local state institutions maintain a crucial role in local economies when they use their discretionary power to set up "patronage" or "clientelist" systems in support of local enterprises (Oi 1995, see also Wank 1999; Walder 1995). This way, local governments increase their revenues from a stable tax base and utilise them to exploit the new market chances (Wong 1992, Oi 1992). Instead of retreating from economic decision making, local governments have a strong incentive to expand economic interference in firms under their jurisdiction. This is a trend that runs counter the 'phasing out' of state interference. These studies contribute important insights in the role of state-firm networks and the diversity of local situations.

Guanxi and "entry modes" for multinationals (not to be discussed here) are the main focus of management science literature. This literature tends to use guanxi as an exogenous factor to explain Chinese business behavior and comparative advantages (Davies et.al. 1995; Kiong and Kee 1998; Park and Luo 2001; Xin and Pearce 1996). Guanxi are seen at work in overcoming resource constraints, such as the lack of managerial talent (Carney 1998; Bruton et.al. 2000), generating legitimacy for private firms (Ahlstrom and Bruton 2001; Redding 1996) or ensuring favourable taxation and administrative facilitation (Peng 2000). The case study approach with its wide-ranging generalisation is predominant in this argumentation. The drawback is that without operationalisation the contribution of guanxi to firm performance cannot be measured. Many authors are aware that the broad essentialist concept of guanxi forestalls analysis of differences in business behaviour and functioning of markets in China.

Another stream of literature addresses the wide diversity in economic performance and ownership relations among all forms of private enterprises or enterprises in transition, including TVEs (first in Byrd and Lin 1990:3-18, see also Putterman 1993; Oi and Walder 1999; Whiting 2001; Hsu 1999). Such diversity cannot be explained by referring to national legislation or theoretical positions in the approaches introduced above. These studies show that economic transition depends on more than the direction and speed by which socialist institutions get dismantled. Institutions matter, as do the local conditions under which new institutions replace old ones. Management science literature and social psychology offer the notion of guanxi as

one, if not the single most crucial factor, for explaining the emergence of new institutions and organisational forms of firms in China. They draw heavily on the anthropological studies which sometimes contribute a non-economic perspective to the discussion (and confusion). These studies aim at clarifying the notion of *guanxi*, as meaning social relations built on “pre-existing relationships of classmates, people from the same native-place, relatives, superior or subordinate in the same workplace and so forth.” (Yang 1988: 411), or when they clarify other components governing such relationships, such as trust, “face” or moral obligations (Smart 1993). *Guanxi* is often described as a core element of Chinese economic behaviour (Bian 2001; Wank 1996), even though the social aspect might dominate when *guanxi* is said to “acknowledge[s] the legitimacy both of seeking the accomplishment of instrumental aims through friends and of building relationships through mutual support and exchange, so long as the instrumental use is subordinate to the cultivation of the relationship.” (Smart 1993: 404;). This view insinuates a dichotomy between market behavior based on an economic calculus and Chinese behavior based on a value attached to social relations. This dichotomy was one of the starting points for research summarised here and forms an important part of its agenda. *Whether Chinese business behavior employs the economic calculus within the boundaries set by guanxi, or whether it acknowledges pre-existing ties within the boundaries defined by economic reasoning is an empirical question that as is the case with all forms of social capital cannot be solved without knowledge about the cultural/institutional frame of an economy* (Sobel 2003; Wank 1999).

In summary, this study takes up the threads from transaction cost, institutional and social debates and aims to contribute new insights to explain the diversity in property rights, institutions and social structures to research on transition economies with a view to establish *institutional regularities in the transition process*.

THE RESEARCH DESIGN

In transition economics the assumption of exogenously given institution is precarious. Rather, the question is: “How do institutions emerge, do the right institutions/organisations emerge, and what does it mean when one speaks about the ‘right’ institutions?” To start with the last question first. Institutions can generally be assessed by transaction cost criteria, but not so in transition

economies, where transaction costs provide a necessary but not a sufficient condition. In transition economies, institutions not only need to reduce transaction costs, they also need to conform to the rationale and discipline of nascent markets and competition. Entrepreneurs in transition economies face related problems. Entrepreneurship is not confined to the technicalities of setting up a firm that efficiently co-ordinates resources. Entrepreneurial activity plays a part in the building of institutions that will more and more facilitate voluntary exchange and the use of the price mechanism.

The research applies a broad definition of institutions and attributes the emergence of institutions to three elements: the players, the rules of the game, and the strategies of the players within the game (Nelson 1994; North 1994; Aoki 2000, 2001).

- *Players*: Taking into account what we know about guanxi, it is crucial to find out how economic agents use or create *social relations* when having to choose their business partners in a nascent market environment. ‘Persistency’ of old (bureaucratic) links is addressed in questions that investigate the choice of politically and administratively defined business partners. In contrast, new social relations emerge in response to questions addressing non-political and market related criteria. These links seem to be more stratified and to connect people horizontally. The extent to which family members, friends, the village, or class mates is questioned here to account for the standard guanxi. Beyond that, special emphasis is put on catching any business links that lie outside the standard guanxi. It is assumed that “embedding” a firm in social relations is a major entrepreneurial activity in all transition economies that in the end helps define shareholders as well as stakeholders of any firm or investment.
- *Rules of the game*: Once economic agents have dismantled bureaucratic procedures in a transition economy, they need to invent new rules on how to conduct business transactions. In other words, they have to create new and effective *modes of governance*. The binding force of modes of governance either depends on the silent consent of players who take them for granted as custom-based forms of governance. Alternatively, new modes of governance need to be “architected” through bargaining and codification. Again incorporating the literature on guanxi, the research distinguishes between relational governance and contractual governance. Relational governance refers to business relations built on trust, moral obligations, and reciprocity. Contractual governance refers to business relations built

on (written or unwritten) contracts, employing market discipline (exit) or recourse to law as enforcement mechanism. Specific questions focus on each of these modes.

- *Strategic response of entrepreneurs*: The research design assumes that entrepreneurs will react systematically (or strategically) to procedural uncertainty in their external environment. Procedural uncertainty can be caused, for example, by the newness of the private business sector, by a weak institutional framework at national and local level, and by changes in national or local policies during transition. Entrepreneurs choose organisational arrangements to help them cope with the special transaction costs created by procedural uncertainty. In China, the diversity of organisational forms of firms and in institutional arrangements around business relations illustrates the degree of procedural uncertainty. This makes *organisational choice* the third major category of questioning. Organisational choice is examined by asking which factors and motives influenced the selection of specific organisational forms and what caused the switch from one to another organisational form. In light of the literature on guanxi, the empirical study did not confine its questions to transaction costs alone. Beyond asking for the motives for entrepreneurship or investment in business relations, respondents were also invited to list additional social or political motives for creating organisational links and structures. For example, the study queries the widespread assumption that Chinese entrepreneurs have a tendency to build up a family businesses.

This research examines how entrepreneurs choose the “right” organisational form for a firm, select the “right” social relations for embedding business activities, and create an adequate form of governance in order to minimise transaction costs. We observe to what extent their choice depends on location and the interplay between the entrepreneurs and the political leadership on whose support the existence and success of private business dealings may depend. Two situations were singled out as essential for the development of private business from an entrepreneur’s perspective. One is *the establishment of a firm* which involves pooling, exchanging and remunerating resources in an uncertain institutional environment. The other is the *management of a firm* or, more precisely, the establishment of long-term business relations with customers and suppliers and possible other partners.

THE EMPIRICAL STUDY

Methods

Over a hundred interviews were conducted with Chinese entrepreneurs between 1999 and 2003. The data were collected in three Chinese provinces, *Zhejiang* [2001, 2002, 2003], *Jiangsu* [2001, 2002, 2003], and *Shanxi* [1999]. Only those firms were included in the sample that were non-state and appeared relatively “free” to establish firms and choose business partners according to their ideas about business relations and *guanxi*. In the end the final sample consisted of eighty-one private firms that met the requirements of autonomy and a hard budget constraint.

Similar to other studies on business and entrepreneurship development (e.g., Fillis, 2002), we used a twofold approach, namely a combination of in-depth interviews and standardized questionnaires. The interviews made use of two different sets of data. First, the life history and the governance structure of the respondent's firm was collected by means of open questions. Second, a questionnaire consisting of closed questions was used to further investigate the governance structure and configuration around firms. Selection criteria were applied to ensure that urban as well as rural firms, and not only firms working in traditional sectors but also firms working in modern sectors were included (Table 1). Firms were stratified by size, location and business sector. Despite these efforts the sample selection is biased to the extent that the respondents' firms were selected with the help of local institutions, such as academic network, banks, corporate networks, and local tax offices. Moreover, the observed tendency of Chinese firms to change sectors limits the usefulness of statistics on sectoral distribution as these cannot offer more than a snap shot.

Insert Table 1

A word on the representativeness of the sample: Chinese provincial statistics offer a poor basis for checking how representative the sample is. As Table 1 shows the categories are too broad for analytical purposes, as they still reflect administrative responsibilities of the former ministries rather than different output, production techniques, or industries. The sample does not attempt to present a systematic comparison across provinces. Provincial data use different calculation

methods and changing definitions for private enterprises. The diversity at the (in particular) local institutional level and the heterogeneity in Chinese culture challenge the usefulness of constructing indicators that claim to represent an overall picture. Modern management literature argues that “modes of rationality are built out of locally available conceptions” that are derived from “local practice/custom shaped by culture or institutions” (Clegg 1990, 158). Constructing representativeness at an aggregate level comes at the price of disregarding information which might be crucial for explaining specific features of local entrepreneurship and diversity. For these reasons the following refrains from presenting results a numerical form, a technique that would suggest a generalization far beyond what the quality and quantity of the data permit.

Instead, we decided to choose a qualitative approach as our study is mainly exploratory, that is, we had no preconceived expectations on what the organisational and governance structures of the Chinese firms as well as the configurations around them would look like. As a consequence, no sophisticated scales to measure the different structures and/or configurations were included in our questionnaire, which would be a prerequisite for inference statistical data analysis. Instead we chose to offer the respondents a large number of different alternative responses to cover a wide range of different possibilities.

As the participants of the study preferred the interviews not to be taped, notes were taken during the interviews and transcribed shortly afterwards. Interviews were conducted directly in Chinese without relying on interpreters. The questionnaires were bi-lingual with the Chinese language version used for the interviews. All empirical research took place in close collaboration with Chinese partner institutions, which aside from assisting in the conceptualisation of the study helped selecting and finding interview partners.

Sample

The following gives a short overview over the data set.

1. *Function of respondents.* The respondents typically had a central position in the company: Fifty-six per cent of the managers were CEOs [directors, general managers], about fifteen per cent described themselves as owner/managers. The managers are young, the average age of the respondents were forty with the youngest being 28 and the oldest being sixty-one years of age.

2. *Geographical distribution.* The interviews took place in three provinces. The data collected in Shanxi [1999] provide almost fifteen per cent of the total data, the data collected in Jiangsu and Zhejiang [2000, 2001 and 2003) provided twenty seven per cent and fifty eight per cent respectively.

3. *Sectoral distribution:*

Insert Table 2

4. *Size.* As a rule new firms are small. Forty per cent employ a workforce of forty or less employees; one third have a workforce between forty and two hundred employees, while somewhat surprisingly over one quart [28,4 %] per cent had a workforce of over 200.

5. *Turnover.* The small to medium size of enterprises is also reflected in the figures for annual turnover. Almost one quarter [23.5%] record a turnover of ten million or less RMB (1.2 mil US-\$), thirty per cent a turn over between ten and one hundred million RMB (1.2 to 6 mil US-\$), almost the same percentage [28.4%] a turnover between one hundred and five hundred mil RMB (12 to 60 mil US-\$), while nine per cent reported a turnover of five hundred million or more. That ten per cent of the respondents did not want to reveal their turnover did not come as a surprise.

6. *Age of the firms.* Adjusted for the year of the interview the data show that half of the firms were established in the eighties, forty per cent in the nineties, and ten percent existed earlier. These answers should not be taken at face value. In particular when firms „grew out“ of the old village economy, respondents found it difficult to name a date that marked the end of a socialist firm and the beginning of a new TVE. Moreover, those respondents who claim that the firm was established before the eighties when no private firms existed obviously fail to see the difference between a socialist firm and the type of firms they manage at the moment.

In what follows no attempt is made to analyse the data with respect to these socio-demographic data. The reason for doing so are empirical and conceptual. It transpired during the fieldwork

only how much problems respondents had in naming the date when the firm in its present form was established, or naming core activities. Any attempt to ascribe certain features to one firm implies more arbitrariness than can be justified in an analysis that aims at including dynamic elements. In short, the description of the sample offers a point of reference with no claim that the situation is the same by the time the results are published.

HOW TO ESTABLISH A FIRM?

The external environment

One legacy of the past are missing or „fuzzy“ property rights, lack of capital in private hands, and the [still] high share of assets and input under state control. The first hurdle for entrepreneurs are the technical aspects of establishing a firm, namely buying assets and machinery or leasing buildings, including borrowing money. As in all transition economies, assets [including money and the licence to produce or export] need to be pooled by involving those in control of these scarce assets to join the „founding father“ in some form of partnership or transfer the right to use assets in return for money or various form of favours.

Another legacy of the past is *uncertainty* meaning that [Krug/Polos 2004]

1. entrepreneurs faces a low general level of business expertise in the society at large. There is no one to be imitated and no established procedure to follow. Expertise cannot easily be acquired, neither with the help of formal or informal education nor can it be bought. In short, *the newness of an activity and its organizational form pose challenges for entrepreneurs.*
2. there is no collective memory about what can go wrong, as there is no past experience or routine upon which economic agents can rely.
3. there is no general knowledge about (excess) demand, price- or income elasticity of demand, let alone systematic research that would help an entrepreneur to calculate the market risk.
- 4.

The organisational forms of firms can be expected to reflect these shortcomings of the business environment.

Who owns the resources?

Typically firms are owned by some form of collective and not by one individual. Yet, to conclude from this result that the inherited structures prevail would be misleading as the following figures show. Only 18.5 per cent of the interviewed firms admitted that a state firm or other stage agency, such as the village, are the ultimate owners. One quarter of firms are owned by a family [10 %] or by a group of [less than six] friends [15 %]. Family ties or shared sentimental ties and norms are the background from which these entrepreneurs will start their business. In these cases that rely on traditional *guanxi* we can expect that relational governance will be used for allocation resources, co-ordinating activities and remunerating input. Another quarter of firms were established by groups of investors, i.e. economic agents that provided [monetary] loans in return for interest, but were not involved in the management of the firm. This is a different from the above form of *guanxi*, more akin to networks, where economic actors with complementary economic interests, in this case those in need of financial means and those who search for investment opportunities, agree on “collective action”. They employ contractual governance when using written or unwritten contracts that stipulate interest rate and/or length of contract. Another large part (26%) were Schumpeterian entrepreneurs relying on loans from friends or family members which came with harsh conditions and not as gifts. The overall picture is that the majority of firms started off embedded in various forms of *guanxi*. However, we observe that these *guanxi* can be market conform, provided hard constraints and use elements of contractual governance.

The diversity of ways in which firms are embedded in old structures, in private social relations and in networks based on common economic interest, is also confirmed when one looks at the sources from which firms acquired their assets. Nearly half of the respondents report to have been the recipients of funds from local governments, twenty per cent name family loans, thirty-six per cent report funds received from private investors and forty per cent from banks.

It is worth emphasizing that bank loans became available only since the middle of the nineties while before entrepreneurs had to rely on funding or loans from local government, friends or the family. Yet, this does not change the overall picture that new firms when it comes to acquiring the initial endowment of a firm rely on old social relations inherited from the past or new social relations with a clear economic rationale. The generally assumed predisposition for social relations based on family or friendship ties was less important than the literature suggests.

The fuzziness of property rights can only partly be explained by the lack of national legislation. Often enough fuzziness reflects strategic manoeuvring of firms in an environment of uncertainty. As the open question in the interviews revealed, that fact that more than half of the firm officially state that they distribute profit according to shares needs to be taken with a grain of salt. Most firms do not pay any dividend, but re-invest all net profit. This does however not mean that the “owners” of assets remain unremunerated. Instead of dividends they can claim part of the cash flow of a firm when they ask the firms to take over part of their personal expenses [travelling, cars, banquets]. With no record who owns what, it is reasonable to surmise that all those who succeed in claiming part of the cash flow of a firm are *stakeholders*, entitled to remuneration. Unsurprisingly, there is no formal “corporate governance” [see also Vishny andXXX] to regulate this status. In the absence of boardroom meetings that would indicate contractual, market conforming governance, or “orders” from state agencies that would indicate the still working old governance structure, the decision making between “owners” or better, stakeholders, in firms is characterised by constant negotiations in which the expectations of the different stakeholders get reconciled. To put it succinctly, the interests of stakeholders and more recently shareholders in the new firms are co-ordinated and streamlined through relational governance rather than contractual governance.

Physical assets

Lack of infrastructure was not seen as a major hindrance for entrepreneurship. Nearly 90% of the respondents regarded the road/rail/air transport infrastructure as important and adequate, the same was reported for communication, such as telephone, fax, internet, or email. Three fourth of the respondents regards the availability of supporting financial services (e.g. banks) as important and sufficient. Likewise, the same percentage regarded the availability of land of as important and also adequately available. This might reflect a systematic bias. Those companies that were interviewed were those who obviously knew how to overcome the resource constraint inherited from the past. Another factor contributing to this favourable picture could be that the well-developed regions in Jiangsu and Zhejiang dominate the sample. Yet, as further talks confirm infrastructure seemed to be no longer a major hindrance for entrepreneurship. The picture changes, however, when it comes to human and social capital.

Human capital

Human capital is seen as the most crucial factor in the initial endowment of firms. Unskilled labour is dismissed with only twenty per cent regarding it as important and the majority insisting that it is adequately available. This is no surprise in a country characterised by un- and underemployment. On the other hand ninety per cent of the respondents think skilled labour as important with half agreeing that not enough skilled labour is available.

This result points to a feature in Chinese entrepreneurship which only recently caught the attention of the outside world. Many Chinese entrepreneurs are not content with producing low price-low quality goods for which unskilled or semi-skilled labour would suffice. Instead they invest in new technology that demand a higher share of educated employees. As the open questions confirmed, a great many entrepreneurs want to become integrated in international production chains.

Nothing illustrates the importance of human capital better than the fact that virtually all respondents insist that managerial skill is the most crucial success factor for the firm. Yet only half of the respondents agreed that managerial talent is adequately available. The scarcity of managerial talent can explain the great number of firms that got privatised by *management buy outs* (MBOs). Successful managers converted part of the performance-related salary into shares. A clearer picture of this trend will be available only after the incorporation of firms in China will offer more comprehensive records. Yet as the open interviews and other empirical studies show, firms in which the former manager turned into the owner [or at least acquired a substantial percentage of total shares] seem to dominate the new private sector. An example will be given in the case study below. The life histories of the firms confirm that the minor role of the family in the emergence of a private sector is caused by lack of private savings within families, but equally, if not more, by the lack of managerial talent for families to draw on. This was one of the reasons for potential entrepreneurs looking for alternatives when they established a firm [Hendrischke 2004].

All in all, regardless whether managers were appointed by political authorities on the basis of inherited structures of social relations, or appointed through connections with those in control over scarce resources on the basis of friendship ties, all managers faced strong incentives to

perform. In this aspect the establishment of firms followed economic reasoning and contractual governance best documented in the crop-sharing kind of contract by which managers were employed [Krug 2003].

The following case illustrates the crucial importance of management skills and the way the track record of a successful manager is decisive in structuring an MBO and corporate activities linked to it. While the deal would not have been successful without personal relations, it is evident that the personal relations were spun around one specific individual with a view to secure his long-term cooperation and commitment. The successful manager had in fact a choice between networks whose members were competing for the asset managed by him.

Case [2003 Interview 010]

A second generation MBO: Incorporating Managerial skill

First generation MBOs were characterized either by pressure from below, when managers who had set up their enterprises claimed their property rights, or by policies from above, when local administrations were asked to devolve property rights in collective or small state-owned enterprises to managers and de facto, though not de jure, owners of enterprises. Depending on the local political environment, these MBOs happened from the late 1980s to the end of the following decade. Second generation MBOs can be observed post-2000 in different localities. These second generation MBOs were pursued mainly by local government institutions under pressure to complete overall privatization in their jurisdiction.

Whereas first generation MBOs gave considerable lee way and decision making power to local authorities in terms of fixation of asset prices, debt transfer, privatization schedules, share allocations to managers and labor regulations, second generation MBOs happened in a much more regulated and transparent environment. Local administrations were under much more pressure to publicly justify their actions and to avoid the impression of favors to and protection of special interests. Second generation MBOs in more advanced provinces also were now supported by banks and experienced financial investors able to back management in their negotiations. The change in procedures from first to second generation did not happen suddenly, but in stages that gradually increased public accountability and transparency.

For example, in Suzhou, an internal Party document specified privatization procedures through 2002 and until April 2003, public auction was made mandatory. Up to that date, local authorities had the option to proceed by 'internal transformation (neibu gaizhi)' or 'Internal agreement (neibu xieyi)', which allowed them to negotiate individual settlements with preferred clients. Since April 2003, in this local instance, a reserve price for assets has to be established on the basis of an asset evaluation, and investors are invited to submit their bids. The ensuing auction has to be repeated at least once if the reserve price is not reached. Only in exceptional cases are local authorities allowed to deviate from this procedure.

The MBO in which Mr. Niu was involved happened just before public auction became mandatory, but included already competitive bidding between different interested parties. Mr. Niu's bid was

also no longer the traditional take-over of an asset, but a sophisticated operation in a highly dynamic environment. Mr. Niu is a self-made man who had to make his way up from the bottom of the hierarchy before he became general manager of a state-owned three star hotel in the Suzhou New Development Zone in 1997. By this time, he had acquired a university education in night classes and was on the way to get an MBA degree. The owner of the hotel, the Suzhou New Development Zone Management group also owned a four star hotel and three commercial companies. Mr. Niu managed to place this hotel into a market segment that gave him occupancy rates of 95 per cent and left him without serious competition.

When his hotel came up for privatisation in 2002, Mr. Niu had witnessed one of the last cases of first generation MBO in his group. The general manager of the group-owned four star hotel was able to negotiate a deal with his management corporation that gave him a share of 35 per cent in a deal that was worth over one hundred million yuan. The money he needed was borrowed from a local bank that accepted the hotel, i.e. his future share in the hotel, as a security for the loan. Shortly after, these kind of deals were banned under banking regulations.

For the privatisation of Mr. Niu's hotel, the management corporation as the owner used 'internal agreement' procedures to find investors and finally came up with a list of five interested parties. All competing parties approached Mr. Niu and made him various offers, seeing that Mr. Niu was crucial to make the asset profitable. Mr. Niu eventually decided to throw in his lot with the only group of investors that offered him a share in the deal. Once Mr. Niu had reached agreement with the three investors, the deal with the management corporation was finalized within a week, as his group offered the best price. The three investors acquired shares of 38 per cent, 32 per cent and 25 per cent respectively and helped Mr. Niu to acquire a share of 5 per cent out of the deal worth 21.5 million yuan.

Unlike many of the first generation MBOs, this deal did not secure Mr. Niu control over the asset, nor did it tie him to his position indefinitely. The contract he signed with his co-shareholders was limited to three years on his insistence. Mr. Niu had calculated his options very carefully. The period of three years was the medium term for which he could foresee that he would be able to maintain his competitive position in the local market. More importantly, he had decided not to push for a larger share, although he knew that his investors had granted a 10 per cent share to another general manager in a similar project elsewhere. What counted more for him was that the share he held jointly with them served as an entry into their business network and turned him from a manager into a shareholder. The three business partners, keen to keep Mr. Niu committed to their hotel enterprise, offered him shares in other investment projects and gradually expanded his role beyond his original position into a fourth shareholder in their real estate and agricultural businesses. What appeared like a management incentive share turned out to become a substantial form of co-ownership. It would allow Mr. Niu to withdraw from the hotel and concentrate on other activities should the grounds of the hotel at some stage be re-zoned for residential usage. This would increase the land value more than four fold and possibly make continued hotel operation an unprofitable option in the longer run.

Organisational form.

The questionnaire asked how firms registered and how often they changed their registration and organisational form. The resulting picture remained highly complex for the following reasons: First, In particular at the beginning of the reforms there was no organisational choice. Instead

young entrepreneurs or the local leadership waited for national or provincial guidelines. Second, as was shown elsewhere [Krug 2003], the organisational form as documented on in official documents or on business cards is a poor indicator for the actual form of firm. In the case of data on Shanxi collected between 1995-1999, the actual governance structure and the type of firm as printed on the business card matched only in fifty five per cent of the cases. Aside from ignorance, the registration often enough served the purpose to hide private ownership by, for example calling the firm a TVE. In general, the ownership regime and economic nature of each firm had to be “constructed” during the interviews. The formal criteria, such as legal form, type of registration, etc., did not provide sufficiently reliable information on the degree of autonomy the management of the firm enjoyed. Based on information about the founding history of the firm, it normally took several question to ascertain who was the claimant of residual income (profit). More comprehensive information would flow from questions about stakeholders entitled to part of the companies cash flow, entitlements to using the firm’s facilities or accounts. Information of such detailed nature was not always forthcoming and required rounds of questions.

Finally, we noticed that by relying on quantitative data collected over different years one easily misses the dynamics of Chinese entrepreneurship. Case studies as the one above, *harden* the weak evidence that suggests itself in the quantitative data. A cautious interpretation of the life histories points to the following trends in organisational change [Hendrischke 2003]: The first stage of entrepreneurship led to the “localisation” of firms when local authorities were needed for both acquiring resources and protecting property rights. The form of a TVE offered an organisational form that could command the highest local protection [see also Yep, McNally]. With increasing business success accompanied by MBOs a mix between private and public “ownership” became the dominant form of firms. This was facilitated by changes in legislation by which private persons and firms were acknowledged as rightful owners of capital assets. The implementation of the company law offered the possibility to incorporate companies either in form of limited liability companies or in form of corporations. In our sample, the first form dominates the private sector irrespective of whether the firm started as a collective firm inherited from the past or as a private or family business venture. In all cases the motive behind the incorporation seems to be the conversion of stakeholders into shareholders [see case study].

Discussion

Relying on the quantitative data and life histories the following pattern emerges. Which type of new “private” companies were established depends first on the *intention* of the founding fathers. In the case of China this group is dominated by friends or local jurisdictions; and second the way *resources* were *mobilised*. The dominant feature is that mobilisation relied on offering collective property rights to all those in control of scarce resource and willing to contribute to the establishment of firms. In return monetary incentives were offered either in form of a share in residual profit, or (more frequently used) access to the firm’s cash flow. Managerial talent, seen as the most crucial scarce resource was recruited on the basis of incentive contracts which beside performance-related salaries entitled managers to future ownership. Which type of new firms emerges depends further on the *interaction* between entrepreneurs, political authorities (as regulators) and intermediate institutions such as (political) connections, social networks such as friends, and increasingly more on market intermediaries such as banks. Finally, which type of firms emerges depends also on the *social embeddedness* of a firm. How to embed a firm followed some *constitutive beliefs* (Scott 1995) of the founding fathers, namely that

- firms need to start with a strong local rather than organizational identity. Virtually all interviewed firms started by searching for local resources, producing for local markets, inviting local stakeholders, and negotiating with local regulators.
- firms benefit from accepting local political stakeholders, if not shareholders. Mixed ownership is seen as the “normal” way for establishing a firm. Aside from transaction cost considerations such as access to information, licences and property rights protection, the involvement of political stakeholder is seen as a way to attain legitimation as a new organization.
- contractual governance and market operations needs to be embedded in relational governance that allows accommodating the demands of the inherited political structure and the social demands of the near environment.

The last point will be taken up in what follows when it is asked how firms start and safeguard long term business relations.

HOW TO ESTABLISH BUSINESS RELATIONS

External Environment

The change from bureaucratic procedures for co-ordinating economic activities to voluntary exchange is at the core of the transition from a socialist to a market economy. In transition economies uncertainty and the newness of a private sector generate formidable thresholds for starting private production and exchange. In practical terms, private entrepreneurs may come under pressure to remain in well-tested networks with state officials, in particular when these use personal *guanxi* to further their private interest. These links might offer higher returns in the short run, but also impede them in forming and expanding new business with private partners (Yang 2002).

Where remnants of state monopolies and officials dominate factor and product markets, new firms without the possibility to choose between potential business partners inside and outside the state sector are severely hampered in their entrepreneurial activities. This is well documented in other transitions economies. As Greif [1993] has shown the selection of trustworthy business partners works as an effective *ex ante* device against such pressures. The availability of personal networks enables private entrepreneurs to employ social, as opposed to economic, institutions as collective agents for co-ordinating the sanctioning of opportunistic behaviour. In China the effect of the reforms on choosing social and business relations presents itself as follows. In the old (socialist) economic system formal positions in the *nomenclatura* and lower bureaucratic echelons were the only criteria that defined the pool of “business partners”, because they provided access to resources. The reforms enlarged this pool by including potential partners with independent access to resources, irrespective of political criteria. Thus, the pool includes all those whose technical competence, control over resources or products is economically valuable for establishing long term business relations. Among the variety of potential business partners firms select those who in addition to their economic value offer social values, such as trust and reciprocity. The resulting hybrids come close to those identified by TCE for market economies, as the constraints set by the external environment is less decisive than the transaction-specific features in the business relation.

The alternative view assumes that social relations and *guanxi* primarily define the pool of potential business partners and that economic activity is rent seeking and essentially structured

around the available partners, In this case entrepreneurs will screen the pool of trustworthy potential business partners for those who in addition to their social connectedness also offer economic resources or a commitment to developing resources, techniques, and products. Relational governance is required match the interests of business partners in order to ensure that, individually or jointly, they invest in the coordinated generation of knowledge or production of goods

The difference between these two approaches is more than a matter of academic contest between TCE and those management studies approaches claiming a Chinese disposition towards social relations. The difference relates to substantial search costs and resulting institutional environment. In the first case firms will search for “hard” data, such as a firm’s capacity, resources base, finances, quality and price. For transition economies with their ill-functioning markets, TCE expects intermediary institutions to emerge, such as banks, consultants or head-hunters able to facilitate the matching of supply and demand. In the second case resources will be spend on searching for the “right” person in terms of connections, trustworthiness, or moral obligations accumulated in the past. The evolving intermediary institutions are more socially oriented and facilitate the exchange of gifts and favours that assist in establishing long-term relations. (Young 1995) Frequent personal contact and exchange of information accompany the relational governance. It is worth stressing that in this case the match between the persons, firms, production techniques, supplier-customer relations defines the economic activity.

Thus, embedding business relations in social relations does not imply the absence of any intermediate governance institution for enforcing business relations. The difference is that in social relations where norms of moral obligations and reciprocity dominate, we see the emergence of social intermediary institutions such as clubs, temples or restaurants emerge that facilitate contact, emotional bonding or moral obligations.

In contrast, in a resource-based entrepreneurial environment, social institutions would establish linkages of incentives, governance, information and knowledge between different business partners. Such institutions can be Chambers of Commerce and Industry, contract laws and court ordering, but also statutes for corporate governance that set incentives to invest in long-term relations while restraining (ex post) opportunism.

On the issue of how entrepreneurs chose business partners, which selection criteria they applied and which mode of governance they used for enforcing business relations, respondents were asked to give details on one important and typical business relationship, generally a supplier or customer with whom the firm traded regularly. The emphasis was on long-term relations, as these are at the core of the development of a private sector. Spot market transactions, i.e. the notorious wheeling and dealing at the beginning of economic transition, were not taken into account.

Choice

More than half of the respondents report that their business arrangement values less than 10 million RMB (1.2 mil US-\$), another fifth values between 10 and 50 million RMB (1.2 to 6 mil US-\$) and again another fifth more than 100 million RMB (12 mil US-\$). The business partners were typically chosen from more than two possible offers. Nearly half of the respondents had even more than five options. The business relations ran for up to two years for one third of the sample, for one third of the cases already between three and five years, for another third more than five years. Only one respondent started a business relation with a family member. Most business partners are located outside the province, only for ten per cent the partner was situated within a distance of five kilometres.

Determinants of choice in business relations

Personal recommendation (guanxi)

Half of the respondents insist that personal recommendation are very important for choosing a business partner while three quarters agree that both respectability and influence within the local community are crucial factors in selecting a business partner. On the other hand, family connections were of almost importance, yet nearly half of the respondents had pre-existing personal or social contact with their business partner.

Yet, business relations need to align with the economic interest involved: Price and quality of goods, reliability in delivering and a high technical standard were decisive arguments for nearly all entrepreneurs in our sample. More than half agreed that their partner was willing to invest

time and effort in the business relation, while to a slightly lesser extent it was agreed that the partner had invested also in capital equipments to specifically meet the firm's needs. Access to capital through the business partner was regarded as equally important. Moreover, the partner's access to business information, new customers, further business contacts in the province and (to a slightly lesser extent) in China or worldwide were also reported by half of the respondents.

While access to networks and relational governance based on norms of reciprocity were important for half of the respondents, membership of those who could broker political influence at the local level was seen as important by one third of the respondents as opposed to fifteen per cent who tried to get access to member that could broker influence at the (central) state level.

Resource constraint

To see whether business relations were seen as a means to the scarcity or non-tradability of resources the respondents were asked to indicate agreement/disagreement that they were chosen as supplier on the ground that the other firms lacked resources. Fifty per cent agreed that the customer lacked technical experience (thirty per cent disagreed), lacked physical space fifty per cent (39 %), financial resources twenty five per cent (69 %), spare capacity to meet fluctuations in demand twenty five per cent (54 %). These figures offer weak support only to the assumption that Chinese business relations are driven by the need to cope with the resource constraint. The picture does not look better in the complementary question, namely when respondents were asked to give reasons why they had chosen a specific supplier. Only thirty per cent agreed that lack of technical experience caused them to embark on a specific business relation while seventy per cent disagreed). The respective figures for lack of physical space was forty per cent (39 %), financial resources thirty per cent (50%), and spare capacity eighteen per cent (54%).

Specialisation gain

To build up a core business or exploit cost advantages was even less confirmed as the motive that prompted the firms for establishing business relations. Asked whether the respondents were

chosen as supplier as the customer faced higher production costs was answered to a affirmative by twenty nine per cent only, while fifty four disagreed. The answers to higher labour costs were thirty eight per cent (40%), lack of managerial time nineteen per cent (59%), while twenty five per cent agreed that they were chosen because otherwise the customer firm would have been distracted from their core business. The complementary set of questions, namely why the respondents had chosen a supplier offer a similar picture. They had chosen a supplier because they faced higher production costs was agreed by twenty five per cent (70 %), higher labour costs twenty five per cent (45 %), lack of managerial time twenty three per cent (64 %), while however seventy per cent agreed that otherwise they would have been distracted from the core business.

Thus on one side “hard economic data” such as quality, price, delivery play a role in the establishment of business relations regardless how the business partner were selected on the ground of personnel recommendations and social contact. On the other side it is very hard argue in the light of these figures that long term business relations are established as a means for overcoming the resource constraint or to appropriate specialisation advantages.

Modes of governance

If it is not the direct economic advantage out of special business relation than the mode of governance might play a role. Whether contractual or relational governance both mode offer incentives and enforcement mechanism for harnessing business relations. One extreme would be relational governance generating incentives for foregoing opportunistic behavior because this is the way it was always done, and because mutual trust, frankness and assistance are seen as the “natural” basis for any business relationship, while the loss of reputation for being a trustworthy partner defines the default for misdemeanor. On the other hand, contractual governance asks for legislation, law enforcing agencies and court ruling as the last resort for enforcing agreements. Whether these two scenarios juxtapose two different sets of incentives and sanctioning was the context of the last set of questions in which espondents were asked why they acknowledged agreements.

The respondents clearly acknowledged the usefulness of contracts and contractual governance. Half of the respondents report that the threat of legal redress motivates them to abide

agreements. All, but a minor group does so in order to safeguard future business dealings with the business partner. For nearly all respondents prompt delivery and the two-way exchange of information is crucial to the success of such a relationship. Even though the willingness of a business partner to acknowledge extra-contractual requests is not crucial for the success of a relationship for half of the respondents, it still is an important argument for forty per cent. All respondents insist that written agreements accompanying a business arrangement are legally binding.

Yet, at the same time, the respondents also confirm the usefulness of social relations and relational governance. Almost all respondents abide by agreements, because they consider it as the conventional way things are done in business. They fear of loss of reputation on the personal level and for the firm. Almost all regard personal honour and the commitment to convention as another reason to acknowledge agreements, while half of the respondents see personal friendship (but not the family) as a major reason for honouring agreements. Mutual cooperation and mutual trust between the respondents firm and their business partner consider all respondents as crucial for the success of the firm. Most of the respondents trust their business partners, that they would not take unfair advantage of their firm should the opportunity arise. All respondents are also convinced, that their business partners trusts them to be reliable. Half of the respondents report that they exchange full and frank information about their business plans with their partners, whereas the other half is reluctant to do so. Personal contact in social settings is considered as important by three forth of the managers. Consistent with the other data, family connections with a wide range of people only plays a minor role for the success of the firm.

Discussion

Overall, the results tend to confirm the prediction of transaction cost analysis that increasing market competition leads to a substitution of vertically structured political networks by horizontally structured networks between firms (Nee 1999). Firms choose business partners for reasons other than political expediency. If political agents are chosen as business partners, this happens because they can substitute market input rather than for social or political reasons. Yet, as the answers reveal, there are also limits to efficiency considerations when business relations are formed. Neither resource constraints nor specialization gains, both important

reasons for long-term links, are seen as most decisive in establishing business links by the majority of respondents. Instead, the importance of personal recommendation or reputation is emphasized to the degree that one has to conclude that efficiency consideration come into force as long as they can be embedded in some form of *guanxi*. In other words, Chinese entrepreneurs and firms combine elements of contractual and relational governance to the degree that they become mutually dependent. A dichotomy between moral obligations and norms on one side and economic reasoning does not find much support by the respondents. As much as this role of relational governance can constitute a strength and be a condition for survival in an institutionally weak environment, it would also have obvious drawbacks, as it limits the pool of expertise available to a firm to what can be integrated within the framework of relational governance.

Interpretations for the smooth blending of different modes of governance could assume different time horizons linked to transition stages or different operational areas in a firm's activities. Some answers indicate that contractual governance dominates current operation which under increasing competition needs to search for the best use of resources, while relational governance dominates the exploration process for investment in future production, capabilities or organizational form in an environment where no risk-mitigating institutions exist. Here the advantage of relational governance to expand exploration beyond the confines of the firm and to exploit its embeddedness comes into play. This interpretation emerged during fieldwork when answers pointed to the need to inquire into visible and removed incentives that might have prompted entrepreneurs and managers to establish business relations.

As life histories and informal talks revealed, in many cases it was not the immediate return for the firm, but acquiring 'options' on future business dealings in the actual or other lines of business, present or future, that prompted the establishment of business links, even for yet to be established firms. The case study offers an illustrative example for this kind of strategic behaviour. Related to this kind of 'real option' policy is the role of networks within the new business sector. Business relations open access to networks that can control underlying property rights and act as entrepreneurs behind the scenes. Their activities can be more crucial for the business partners than the survival of an individual firm. The establishment of business relations with one specific business partner can not necessarily be regarded in isolation or only

with reference to one specific firm, but may indicate expected returns from future lines of business.

As long as systematic research is missing, the results allow only to point to new research areas, such as the linkage and interaction of firms and economic actors with networks and even interaction between networks.

SUMMARY: WHAT NEEDS TO BE DONE?

The results do not allow refuting or supporting any of the theoretical prepositions employed so far in empirical studies. TCE-based analysis or the corporatist model, for example, are not “wrong” in the sense that there is no causal link between the factors they have identified for the economic performance of China’s private sector. Rather, the results indicate that one crucial factor is missing, namely the economic working of social relations or *guanxi*. Yet, to claim as the management or anthropological literature does, that this factor is decisive is neither supported by the field study. None of the existing approaches can explain the diversity in property rights relations, organizational forms of firms, and the different combination of relational and contractual governance that the respondents refer to.

A cautious interpretation of the empirical results show that China’s entrepreneurs share the following assumptions. First, *to embed a firm within a locality* (as opposed to an industry or factor market) *is seen as the ‘natural’ way of starting a firm*. Second, *to incorporate firms as legal persons while keeping local state agencies involved as (minority) stake- or shareholders is regarded as a given procedure to safeguard the operation, expansion and diversification of a firm*. Third, *using efficiency considerations for establishing business relations is not in conflict with guanxi norms, let alone with “Chinese culture”*. *Business relations are embedded in both relational and contractual modes of governance*. These three forms of embeddedness (local society and administration, local ownership structure and modes of governance) can serve as a useful proxy for both the motifs of the “founding fathers” of firms or intermediary institutions, and the ‘taken-for-grantedness’ of inherited business routines.

Seen from this perspective the empirical findings suggest to include embeddedness as a factor explaining diversity (and performance) in and between transition economies. TCE attempts to explain diversity by different degrees of market penetration and different forms of property rights regimes for independent ('disembedded') firms with given exogenous institutions. The empirical findings here point to the working of market penetration and property rights in a different institutional environment which creates its institutions endogenously. Here, the different institutional arrangements that characterise embeddedness are the outcome of a contracting process with respect to local, ownership structure and mode of governance. Such a model is open to empirical testing. Moreover, it can also be assumed that the form of embeddedness shifts over time. With ongoing market penetration economic agents might find it advantageous to disembed a firm, for example by loosening the local ownership connection, while searching for ways to improve the embeddedness in partnership structures that safeguard access to new technologies or other form of input.

On a conceptual level, these findings suggest applying or recycling other approaches in which institution building and the spatial dimension of jurisdictions are endogenised. There is (1) *contract theory* where institutions are not regarded as the outcome of a competition driven process that forces economic agents to choose efficient institutions. Instead institutions are regarded as the result of bargaining or 'contracting' between parties (Libecap 2002). These approaches show that aggregate gains, let's say from a complete property rights-regime, in terms of transaction cost reduction are not sufficient to ensure that such a institution will be established and enforced. For this to happen, the following other requirements need to be met. Small number of contracting parties, ex ante agreed upon sharing rules including compensation for the losers of institutional change, and homogeneity of the parties with respect to institutional or property rights preferences. There is (2) *constitutional economics* which shows that decentralisation of legislation into small jurisdictions of agents with rather homogenous political preferences (ensuring anonymity in voting) leads to efficient outcomes (as deadweight losses can be avoided). Replacing political preferences with institutional preferences, such as the affinity to certain property rights regimes, custom, or business routines, would subsequently allow using the analytical tools as developed in constitutional economics (Buchanan and Tullock 1962; Olson 1969; Blankart 1994). The proposition in this case were that designing jurisdictions where the contracting partners see their preferences for institutions converted into a corresponding supply at low cost will lead to more efficient outcomes (in terms of transaction

costs, compensation funds and deadweight losses). The *Theory on Public Goods (and Commons)* provides enough empirical evidence to make such a research agenda promising. As was shown by Ostrom (1990) communities small enough to ensure information impactedness and frequent contact facilitate institution building, particularly if the community also shares preferences for specific institutions, business routines, or in general certain social norms. The empirical problem for applying these concepts for China, or any transition economy is then to show to which extent economic performance and institution building can be explained by size, interaction, compensation and preferences for business routines or property rights regimes. A further, and more intriguing question is then to inquire to which extent networks are the driving force behind the delineation of such efficient constituencies.

Another result of the empirical study raises the question about organizational forms, organizational identity, and the transitory nature of organizational forms. *Organizational economics* which tries to explain the diversity of organizational forms and different mortality rates of different forms provides challenging insights when it is shown that intensity in competition for resources, age, the newness of firms are factors that explain the co-existence of different organizational forms of firms even if the general trends in market integration and market penetration are accounted for (Carroll and Hannan. 2000). To enlarge the analysis by first looking at all organization (intermediary institutions, and political organizations such as local state agencies), and allowing for other selection mechanism than market competition such as political protectionism, would once more point to the need to better conceptualize networks (Krug and Polos 2004). On one side, as the field study suggests, networks generate and sustain preferences for certain organizational configurations. On the other side networks hinder organizations to “close boundaries” (Nee 2000) thus perpetuating weak institutional institutions which must work to the detriment of efficiency and performance.

All in all, with all the necessary caution the results suggest to include the following factors that might better explain different property rights regimes and different economic outcomes within China, as well as between different transition economies.

- ▶ decentralisation (and jurisdictional competition)
- ▶ local embeddedness of firms (as opposed to sectoral or factor market embeddedness)
- ▶ delineation of constituencies that catch the spatial dimensions of preferences for institutions, property rights and business routines.

Table 1: Sectoral distribution of Privately owned firms
[percentage of total number of privately owned firms in this sector]

Province	Zhejiang	Jiangsu	Shanxi	Data set
Sector/Year	2001	2001	2001 n.a.	1999-2003
Farming.Forestry.Animal Husbandry and Fishery	1,01%	0,72%		
Manufacturing	60,14%	40,64%		60,49%
Construction	1,70%	2,08%		
Transportation	1,14%	0,54%		
Wholesale, Retail Sale, Trade and Catering Service	27,24%	48,91%		18,52%
Social Service	7,50%	6,98%		20,99%
Repairing Trades	0,24%	0,14%		
Others	1,02%	—		

Source: Provincial Statistical Yearbook of Zhejiang and Jiangsu 1999-2002.

Table 2: Classification of companies in the data set

Industry	Frequency	Percent
Semi-manufactured goods	18	22.2
Wholesale, retail, marketing	11	13.6
Household apparel	6	7.4
IT: computer and telecom	7	8.6
Textile	13	16.0
Financial service: real estate, asset management	7	8.6
Tourism: Hotels	6	7.4
Primary products	4	4.3
Food processing	4	4.3
Pharmaceutical	2	2.5
(others)	(2)	(2.5)
total	81	

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