

# China's Institutional Architecture: A New Institutional Economics and Organization Theory Perspective on the Links between Local Governance and Local Enterprises

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# **China's institutional architecture: a New Institutional Economics and Organization Theory perspective on the links between local governance and local enterprises**

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## **Abstract**

We start our exploration of China's institutional change by asking what the China experience can tell us about institutional economics and organization theory. We point to under-researched areas such as the formation of firms and the interplay between firms and local politics. Our findings support the dynamic capability approach which concentrates on activities rather than on pre-defined groups and models institution building as a co-operative game between the local business community and local government agencies. We find that the analysis of firms has to set in before they are formed by entrepreneurs and networks and we identify political management as a core competence of these two groups. While this contradicts the conventional view of clientelism or principle agent relations as institutional building blocks, we don't propose competing models. Instead, we suggest focusing on a dynamic process in which the role of players can change. Faced with the spontaneous emergence of institutions, our concept of institutional architecture captures the fact that the two models can co-exist side by side and that, once the dichotomy between formal and informal institutions is given up, there can be a transition from local patron-client relations to local business-state coordination.

## **Keywords**

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# **China's institutional architecture: a New Institutional Economics and Organization Theory perspective on the links between local governance and local enterprises**

## **Introduction**

Reform China poses a challenge to social scientists trying to use their analytical toolkits to explain institutional change and economic transformation. The dramatic change of China's economic system has stimulated some useful theoretical controversies (Roy *et al* 2001; Tsui *et al.* 2004). In organization theory the controversy started between cultural approaches (e.g. Hofstede 1998; Redding 1990) and institutional theory (Meyer and Peng 2005); in economics between the neo-classical approaches and institutional economics (Lipton and Sachs 1990; Grabher and Stark 1997; Hodgson 1993). Over the years when more "observations" of transformation processes and compatible data sets from European transition economies became available, the necessity to pay attention to the institutional context became obvious (see for example OECD 2005, see also Rodrik 2007; Stiglitz 2002). The Comparative Business Systems literature and macro-economic comparative studies have shown that emerging markets and transition economies do not merely represent a data (sub-) set of conventional assumptions about firms and their behavior (Djankov *et al.* 2003; Whitley 2007). Different institutional frames whether emerging markets, transition economies or market economies lead to different organizational forms of firms and different strategic decisions, adding to the diversity of firms that can be observed worldwide. The institutional debate among economists proceeded from the early North (1990) definition where institutions are the rules of the game and captured by transaction costs to including economic organizations as suggested by Williamson (see overview 1991). In the case of China, the question is how economic actors respond to the decentralization of decision making power and control over resources with which the reforms have started in 1978: How does a non-socialist sector emerge? What new organizational forms of firms can be observed in the non-state sector? How do these firms interact with each other and their business environment? New Institutional Economics (e.g. North 2005; see also [www.isnie.org](http://www.isnie.org)) aimed at explaining both the organizational dynamics, i.e. Hayek's "spontaneous order" as initiated and shaped by the

new economic actors, as well as institutional change as initiated in the political arena and stipulated in laws or (Communist) Party directives (Aoki 2007; Barzel 2002). We use the term ‘institutional architecture’ to denote the institutional framework which encompasses both spontaneous order and politically defined incentives and constraints in order to avoid confusion with the conventional legalistic definition of institutional structures which emphasizes national legislation and property rights. In an environment of economic transformation and institutional change this institutional architecture cannot be static. Its dynamism refers to the process by which new organizational forms of firms emerge, social relations are selected for business purposes, and political–business interaction is established by creating new and harnessing existing social and political structures including national legislation.

Yet, so far the complementary question has not been raised: what can the China-experience, i.e. observations and the findings of empirical research, add to the body of knowledge in institutional analysis. This is what this paper attempts to do, stimulated by some puzzles resulting from the China-experience. They can be summarized in four points:

- (1) How do we explain the quick emergence of *entrepreneurship* and new non-socialist firms in an environment of non-existing (until 2004) formal private property rights and massive state intervention in the operation of firms? How do we explain the emerging diversity of organizational form of firms in the nascent private sector, in particular the fact that the diversity of firms can be greater within one industry than across sectors and industries?
- (2) If culturally determined forms of *networking* (*guanxi*) are the crucial coordinating mechanism and therefore the comparative advantage of Chinese economic actors, by which they respond to ill-functioning markets, how do we then explain the diversity of network and network activities within China, let alone the fact that networking co-exists with market exchange, and competition?
- (3) How do we explain that firms and networks involve *political agents* as members or owners? Why do these forms of corporate governance facilitate private

entrepreneurship instead of rent-seeking, corruption and high entry barriers into industries? Why have private entrepreneurs embedded in local business environments become the preferred partners for domestic and international firms, private and public companies?

- (4) How is the organizational dynamics at the *micro-level linked to macro-level* institutions? What happens when localism, embeddedness and corporate governance rather than national legislation, formal property rights and national markets define organizational dynamics? How do we account for the continued co-existence of formal and informal institutions when transaction cost analysis suggests that informal institutions, such as the use of *guanxi*, are transitory and will disappear with increasing wealth and increasing market competition?

Below we will summarize accepted views on institutional change in China with special emphasis on these four puzzles. We will start by outlining what we mean by institutional approaches. Using the terminology of North and Williamson we will refer to the field as New Institutional Economics (NIE). Originating from the neoclassical paradigm NIE stands for a research platform that includes concepts from organization theory, sociology, political science, social psychology, experimental economics and institutional game theory. Though partly overlapping, we keep organizational theory apart in order to account for its insights in the interaction between firms and their environment, as found in the management science and here in particular the strategic management literature.

In proposing an overarching interpretation of China's institutional change, we emphasize the linkage between firms and networks, i.e. the spontaneous order, and politically driven institutions, i.e. the formal institutional order. We will identify gaps in the literature, as in the case of entrepreneurship; suggest specifications of existing forms of networks, as in the case of non-structured, yet strategy-driven networks. The conceptual use of institutional architecture propels a complementary research agenda which acknowledges organizations as initiators of institutional change, the co-existence of formal and informal institutions, and dynamic processes underpinning institutional change.

## **The field: Towards a broader notion of institutions**

China's economic transformation has spawned so many concepts and approaches within the social sciences that any singling out of specific concepts in our summary can be seen as a "random selection". Yet, seen from the NIE perspective the concepts used follow the academic discourse in the last 20 years within economics and what came to be known as Neo-institutionalism (Kato 1996). Research on emerging markets and transition economies pointed to the explanatory weakness of the early North (1990) and Williamson (1985) definitions of transaction costs and hybrids which failed to explain the diversity in organizations such as firms and the emergence of market conforming (or not conforming) institutions. In response, new and related research agendas produced new forms of institutional analysis. First, acknowledging that Public Choice (overview: Mueller 1989) whose findings are based on parliamentary democracies and therefore incompatible with emerging markets and transition economies can nevertheless contribute to the explanation of institution building and change. It provides concepts for "de-composing" the institutional frame by drawing attention to the allocation of regulatory power within one economy. For China the concept of Fiscal Federalism offers an analytical design for explaining the diversity of local business systems and jurisdictional (Qian and Weingast 1997) or yardstick competition (*e.g.* Besley and Case 1995) in attracting FDI (*e.g.* Huang 2003) and securing private property rights. The literature on collective action, shows further that the emergence of institutions does not only depend on the decentralization of regulatory power, but also on the local interaction between the political and the economic sector and new forms public-private partnerships (Olson 1969; Ostrom 1990).

The insights from Public Choice and theory of collective action also show that focusing on sub-national development and interaction is not just a shift in the unit of analysis from the national to the local level (for China see Li 2005), but implies that firms can be initiators of change and institutional entrepreneurs and not just recipients of institutional constraints and change. Firms contribute to institution building when agreeing on business routines or colluding with local government agencies to "negotiate" regulations, subsidies, or even taxation (Li *et al.* 2006). This analysis led to the State-capture (Laffont

and Tirole 1991; Frye and Shleifer 1997) vs. State-seizure (Shleifer and Vishny 1998; Frye 2002) controversy which centers around the question whether and to which extent the alliance between the local business community and the local state can weaken the national government (as observed in China in the 1990; for Russia see Litwack 2005) where it helps to explain the emergence of a very specific institution, namely tax contracting (tax farming) between the local state and firms (Zhu and Krug 2007; Brean 1998). If institution building is no longer the outcome of the political process alone, then identifying the agents of change and their interaction becomes crucial for the analysis. Elite studies in (economic) sociology (Nee 2000; Rona-Tas 1994) or studies on innovative systems (Whitley 2007) find two dominant agents at the local level: firms and entrepreneurs and local government agencies who drive organizational dynamics, in form of selection of organizational form (Krug and Kuilman 2007), ownership composition (Oppen 2007), corporate governance (Nee and Oppen 2007; Oppen et al. 2002), and as will be shown presently strategic decisions.

The analysis of private, here: non-political, institution building reminds economists of Hayek's "spontaneous order" and private voluntary business activities (see discussion in Aoki 2007; also Barzel 2002; Hodgson 2007). This perspective introduced findings and methods from social psychology into NIE, contributed to the development of experimental economics and institutional game theory and paved the way for recognizing identification and participation, bargaining and tradition in institutional change (Bohnet 2006; Schlicht 1999). These new approaches often in combination with the concept of embeddedness (Granovetter 1985) and isomorphism (DiMaggio and Powell 1983) became known as *behavioral economics*.

The question how to link institution building at the firm and local level with institutional change instigated at central and political level points to a gap in institutional analysis. The literature on fiscal federalism (jurisdictional and yardstick competition) contributes some insights, but does not resolve the question whether to model the link between micro-level and macro-level institution building as "hierarchy", authority sharing or as an evolutionary process.



“Non-authorised” forms of institution building are regarded as “informal” (North 2005). This term is used confusingly. It can refer to cultural institutions, which are assumed to foster informal networking and the emergence of a private sector (Park and Luo 2001; Tsang 1998; Xin and Pearce 1996). The same term is also used to refer to illegal institutions such as black markets or corruption with strongly negative connotations (e.g. Rauch 1991; Tsai 2002). The alternative perspective originates in evolutionary economics, which acknowledges diversity, a multitude of different agents of change, pointing to the need to identify the specificities of social relations such as structures, rules, convention or organizations, (Grabher and Stark 1997; Hodgson 2007). From an evolutionary perspective whether an institution is formal or informal is less important than the link between the individual solutions and institutions (Hodgson, 2007). Adaptation, imitation, (jurisdictional and market) competition, yet also the identification of “niches” where some organizational forms and business practices survive are the crucial analytical concerns.

The analysis presented below suggests that at this stage *embracing a diversity of concepts is more helpful than concentrating on one paradigm or one perspective*. The newness of the kind of institutional change under economic transformation offers incentives and new opportunities to recombine perspectives and concepts.

Having outlined the general framework of our analysis, we will next turn to the analysis of firms and networks. We will argue that under China’s institutional architecture entrepreneurship and networks do not merely react to institutional change but actively contribute to new institutional structures by strategically choosing organizational forms and investing in organizational capabilities.

## **Firms and networks**

When in a transition economy control over resources and decision making power is decentralized and economic actors use the new opportunities, the question of spontaneous order arises. Economic actors enjoy a degree of freedom to organize themselves, establish firms and look for new ways outside the plan to coordinate business relations. By doing so, they establish a new organizational architecture (Aoki 2007) which is an essential component of the institutional architecture.

With a rapidly decreasing state sector, explaining the rapid emergence of private entrepreneurship, i.e. “green-field” firms founded by ‘private’ individuals or township and village enterprises working outside state-planning, remains a challenge for organizational research on China. How firms behave, why they differ, and why some are more successful than others are questions central to strategic management. However, the emergence of firms is seldom raised in both the entrepreneurship and strategic management literature, as first observed by Baumol forty years ago (Baumol 1968; Baumol et al. 2007; see also Aldrich and Fiol 1994; Bianchi and Henrekson 2005). More recently, organizational ecology has drawn attention to the fact that the “blueprints” of the founding fathers have an influence on the firm that exceeds their own life span (e.g. the Stanford Project on Emerging Companies, see Baron and Hannan 2002). A second gap in research is that cultural and historic approaches fail to explain the heterogeneity of firms (within one sector) and diversity of local business systems that emerged after the reforms as both concepts generalize at the aggregate level of the Chinese nation state. Thus, for example, the claim that the Chinese family is the backbone of firm formation in Reform China (e.g. Redding 1996) did not pass empirical scrutiny (Pistrui et al. 2001). To simply assume that culture and institutions affect economic behavior is meaningless if there are no predictable consequences (see critique in Hamilton 2006: 7-10; Singh 2007). To assume that institutions are embedded in culture or that culture defines informal institutions (Hofstede 2007; Redding 2005) is to say that a specific behavior can be attributed to cultural as well as institutional factors. For example, the fact that entrepreneurship in China is based on collective actors connected in a network structure can either be taken as evidence for Chinese culture where personal relations (*guanxi*) play a major role. Alternatively, *guanxi* networks can be explained as a response to

institutional factors, such as ill-functioning markets. Likewise Bohnet's (2006) claim that institutions (1) create incentives; (2) co-ordinate behavior; (3) match people leading to a congregation of like-minded business partners; (3) affects preferences in particular intrinsic and extrinsic motivation and the relationship between the two, and (4) provide information on procedures (and not only outcomes) can in the same way be made for the functioning of culture. Research on *guanxi* does not contribute to our understanding of "culture" so long as we cannot better discriminate between institutional and "cultural" factors.

Our research in China indicates that the formation of firms should be treated as a specific area of research. *Firms in China are the outcome of individuals or groups (such as villages) pooling resources and making strategic decisions on how to build up organizational capabilities to best exploit market opportunities and secure a relative stable local institutional environment in a dynamic environment.* The pooling of resources is not limited to physical resources or capital. As shown by Boisot and Child (1996) more than a decade ago, "intangible assets", such as access to market information or prior knowledge about policy changes, are crucial components in the initial endowment of firms. Moreover, in an environment of rapidly increasing competition with fluctuating relative prices and incessant political change, firms opt for a strategy which secures maximum flexibility in recombining productive forces. One of the most striking features of Chinese firms, namely their willingness to disinvest otherwise profitable enterprises, such as restaurants or joint ventures with foreign companies, finds its explanation in the fact that both offer access to capital and are seen as cash cows which enable the investors to move to other, more preferred sectors. Likewise the willingness of private firms to offer shares or influence in their operations to local government agencies is a move to attract stake- holders or share holders who are able to increase the organizational capability of a firm (Oppen 2007). Firm formation in China is thus an iterative process that involves changes in product, labor, financial or even political structures with the aim to find the best adaptation to and embeddedness in a dynamic local environment. Combined analysis of institutions and dynamic capabilities (Dosi et al. 2000, Nelson and Winter 1982; see also Hodgson 2007) helps explaining the

emergence of firms as well as specific initial resources and capabilities that leads to the differentiation of new firms within the same sector (Peng et al. 2008). The China experience supports the suggestions of empirical studies in the International Business literature that the institutional context of entrepreneurship and competition requires detailed scrutiny. Notwithstanding the merits of the competitive advantage view of firms, keeping institutions in the background or reflected in transaction-costs, forestalls analysis of how institutions function, emerge and change (Yamakawa et al. 2008). Combining an institutional analysis with the concepts of dynamic capabilities promises new insights, as has been acknowledged in the strategic management literature; for example, by showing that strategic political management creates firm-specific value (overview in Pearce *et al.* 2008; see also Stark 1996). Our research shows that a strategy of co-opting local political agencies for protection of assets and business relations increases the value of all tangible assets plus business relations irrespective of product, sector or technology. The expected scale economies for investment in political ‘capital’ explains why Chinese entrepreneurs attach so much value to this strategy.

While there is a relative deficit in the analysis of entrepreneurship, the analysis of networks seems to be burdened with a proliferation of concepts. Both cultural and institutional approaches accept that networks in China are a crucial feature of the business environment. The *cultural essentialism* which conflates Overseas Chinese business networks and business networks in the PRC has shown a remarkable resilience against the critique from China Studies which point to China’s cultural heterogeneity, differentiation of local business systems and variations in form and behavior of firms (Goodman 2007). There is a pre-disposition to believe that Chinese (but for example not Russian) networks are different, if not unique. The cultural approach stresses the positive effects of networks on economic development while in contrast, institutional and sociological analyses also highlight the harmful effects in form of rent-seeking and corruption.

To describe Chinese realities, networks are frequently modeled via “as-if”- assumptions. To give some examples: networks are seen as “pseudo-families” (overview in Jacobs

et.al. 2004), “old friends” (*lao pengyou*) (Hendrischke 2007); “clans” in terms of governance (Boisot and Child 1996), “state corporatist” in offering patronage (Oi 1995; Walder 1995), if not ‘Mafia’ like (Cheung 1996) or resembling Indian business groups (e.g. Ghemawat and Khana 1998; see also Rauch 2001). Networks are also analyzed in terms of different concepts of social or political capital (see for example Leenders and Gabbay 1999). These research agendas reflect different assumptions and stress different effects of networks, such as their ability to mobilize familial sentiments, generate trust, open access to information, acquire favorable regulatory terms, and mobilize resources. Which model fits best is in the end an empirical question. It is also a necessary precondition for assessing whether networking in China facilitates the emergence of a competitive business sector or leads to rent-seeking and corruption.

The scarcity of empirical research on Chinese networks and their influence on firms has technical and conceptual reasons. Technical difficulties arise out of the coexistence of formal and informal components of networks. Thus, for example the exchange of political and market information is formal when firms get incorporated and when the chosen form of corporate governance sets incentives for stakeholders to provide such information (Oppen 2007). The sharing and exchange of information takes the form of semi-formal procedures when the collusion of interests between local government agencies and firms offers incentives to voluntarily part with strategic information (Aoki 2007; Hendrischke 2007; Rauch 1991); or it remains informal and confidential in a “favor-against-favor” swap over dinner (Tsai 2002; Yang 1994). Second, some business behavior is “taken-for-granted”. The conceptual problems that network participants do not analyze and articulate their own routinized behavior requires a research design that examines different forms of networking, changes in networking activities, and social techniques (whether politically or socially accepted or not) which govern network activities. Open questions, life history of firms, and additional informal dinner talks, re-interviewing firms after policy or strategic changes, make such a research time consuming and depending on close contact to those familiar with a local and firm-level business environment.

Empirical analysis indicates that Chinese business networks are neither family based organizations using trust to coordinate economic activities, nor organizations based on the ability to overcome constraints imposed by an adverse political environment (see contributions in Li *et al.* 2002). We see them as a rational organizational response, not unlike diversified business groups (*e.g.* Hokisson *et al.* 2005) to an environment where the firm as a legal person can only rely on a limited scope of constitutional and legal protection (see also Carney 1998; Xin and Pearce 1996). Economic actors in such an environment require the ability to mobilize resources across a range of local organizations and power holders. As these local organizations and power holders are not only politically motivated, but have an intrinsic public or private economic motivation, local economic actors have to be able to involve them in their economic activities and ensure that they contribute their resources on a long term basis and receive adequate compensation. At the same time, economic actors prefer the degree of administrative interference in economic activities to be reduced to a minimum. In this institutional environment, public-private networks are much better equipped to achieve all these objectives than an independent legal entity in form of a firm. The same applies to the coordination among private individuals intent on establishing and expanding business relations. In the absence of legal guarantees, networks serve to co-opt private partners in order to enforce claims across jurisdictional borders. This makes them superior to weakly enforced legal mechanisms. *Instead of firms engaging in networking activities, we find networks as economic actors engaging in the establishment of “open border” firms that suit their specific requirements.* From an organization theory perspective the openness and fluidity of firms finds its explanation in the control of political capital as a core competence at par with the required commercial competence.

Our empirical observations can be summarized as follows:

- (1) Networks in China are *fluid*, non-structured organizational forms for co-coordinating resources and strategic decisions (see also Peng 1997). They might have a social or functional group (such as investors) as a core yet expand or shrink according to business opportunities and constraints. Networks are economic actors able to activate and de-activate their membership in line with

commercial opportunities. The dynamic capabilities of networks include the ability to accumulate technical and organizational capabilities and to allocate property rights to firms, investors, stakeholders or managers. By the same token property rights can be re-allocated or firms can be closed down in case of failure or if a recombination of assets promises higher returns. This fluid concept of property rights is akin to socially generated property privileges, but at the same time exploits the legal benefits of incorporation. It is in striking contrast to the legal concept of private property rights which are granted and protected independent of the (profitable) usage of resources.

- (2) Networks with their formal and informal information channels make it possible to convert informal *ad hoc* practices as employed between firms or between firms and local regulatory agencies into procedures or, by extension, into sectoral and formal local business standards. In this sense networks are institutional entrepreneurs, and initiate entrepreneurial activity that precedes formation and strategic decisions of firms (see an interesting example in Child et al. 2007). At the same time, networks give voice to firms in the creation of local business procedures and thereby generate firm-specific value.

While it is acknowledged that transaction cost economics dismisses technical reasons for network formation (e.g. Englander 1988; Milgrom and Roberts 1990) and externalities on the demand side, our research prompts us suggesting to include the further aspects in the analysis (see also Dow 1987):

*Power and authority relations.* Networks as business groups where firms (Ghemawat and Khana 1998; Rauch 2001; Weidenbaum and Samuel 1996; Hoskisson *et al.* 2005) are established to overcome information, or enforcement problems alone, are too narrowly conceived. Instead we argue that networks serve as a means and strategy for co-opting local government agencies. Our research also warns us to assume that the closer the ties with local politicians or administrators, the more productive the network (see also Nee and Oppen 2007). Our findings support the dynamic capability approach which

concentrates on activities as a co-operative game between the local business community and local government agencies. This seems to be in contrast to the patron-client relationship in local state corporatism as formulated by Oi (1995) and Walder (1995) for the early reform period. In local state corporatism one partner, i.e. local government agencies, defines hard constraints to which the other, i.e. firms and entrepreneurs, need to comply (see also Jiang and Hall 1996). We don't see these as competing models, but rather as part of the dynamic process in which the role of players can change. Our concept of institutional architecture captures the fact that the two models can co-exist side by side in different provinces and that there can be a transition from local state corporatism to local business-state coordination.

These findings which stress the effects of networking cannot lightly be dismissed as transitory; they rather suggest a need for better integrating the literature on principal-agent relations, or rent-seeking with approaches on mutual dependency, but also on political competition and game theoretical explanations on cooperation.

*Social relations.* Chinese networks do centre on personal relations, which may, or may not be mobilized for economic purposes. However, once the collaboration has outlived its productive usefulness, the business side of the relationships is de-activated, while the social side remains. It is this activating – de-activating mechanism, which allows economic actors to adapt quickly to changing economic situations at low cost, since the de-activation does not imply the end of a contract, let alone a break of the social relationship. The advantage of personalizing business relations (known since Coleman 1990) lies in the fact that social sanctioning mechanisms can be hijacked for economic purposes. As the management science literature has shown, trust, reputation, and hold-ups all play a role when it comes to harnessing such a form of governance (Nooteboom 1996; 2000, Williamson 1991).

*Capabilities and learning.* From the perspective of organization theory, the analysis shows that the expansion of firms and the development of industries follow dynamic capabilities, here understood as capabilities to actively shape the business environment



and to recombine assets when facing changes in relative prices (Aldrich 2001; Aldrich and Fiol 1994; Scott 1981). By investing in co-opting local government agencies networks increase the value of all tangible (physical, financial) assets and make an investment more attractive as it promises positive returns to scale. Another advantage of the networks is that they function as repositories of productive slack. This function escapes transaction cost theory with its static concept of the firm that does not address the question of how a firm can move from one hybrid to another, except by pointing to the typology of transactions (asset specificity, frequency of contacts etc.). As in the case of entrepreneurship the findings suggest a combination of institutional and the dynamic capability approach (Teece and Pisano 1994, Langlois and Foss 1999) which would also help to clarify whether networks are co-operation rent generating organizations or means of corruption. After all rent seeking depends inter alia on the entry and exit conditions at the local level, (market) competition, but also on the organizational capability to for example force the hand of local government agencies when they engage in ex ante investment while offering ex post justification for certain reform measures (Li *et al.* 2006). More systematic research on networking as a business activity in different localities based on these approaches will help to identify the external conditions and internal resources which explain the organizational dynamic and its costs.

In summary, entrepreneurship and strategic management literature provides conceptual tools to disentangle the perplexing complexity of Chinese institutions. In particular, dynamic analysis and “endogenizing” of networks promise better insights in the diversity of firms and the process by which organizational dynamics at the firm level are linked to institutional change at local level. Networks can be seen as the driving force behind the emergence of a ‘spontaneous order’ at local level that accompanies the institutional change as stipulated by politics and central institutions.

Our findings ultimately stress the usefulness of empirical research using firms, their entrepreneurs and managers, but also local government officials as the main source of information. The potential action choices might be large but, as has been argued elsewhere (Aoki 2007) only a small number can be pursued in specific situations. We

know from the concepts on dynamic capabilities that individual traits such as “visions”, past experience, human capital and social skills, and specific firm features, such as accumulated and remembered knowledge or scope of “collective action (networking)” play a role. What we do not know is what economic actors themselves assess as most promising course of action. Here empirical research is needed to solicit the information about the direction of action (and investment) which in our fieldwork pointed toward access to information and strategic political management, i.e. the capability to influence the local regulatory regime. Only by interviewing a sufficient number of economic actors did we learn that Chinese firms invest first in intangible assets which they regard as necessary condition for any business operation. The informal nature of this kind of organizational dynamics is one of the main reasons for relying on interviews. On the basis of interviews, cross-case study analysis across sectors and localities indicates systematic features in the behavior of firms and entrepreneurs which when turned into hypothesis can be systematically tested at a later stage (see also Uzzi 1996).

### **Linking formal and informal institutions through institutional architecture**

In the case of China organizational forms or business practices become part of the formal set of institution when the Party acknowledges or tolerates them. If this happens at the local level the new organizational forms and practices become part of a local business system, so long as the central level does not object. In other words, as our research has shown three features characterize local institution building: localism, networking and organizational choice. If these three elements are considered institutional building blocks at local level, there is need to articulate the underlying mechanism by which these building blocks influence the formation of institutions (Kornai et al. 2003; see also Peng and Luo 2000; Peng 2003) and how they coexist and interact with central institutions imposed from the top. This underlying mechanism is the interplay between *formal and informal* institutions, to which we have alluded above in our discussion of networks.

For China, the simple juxtaposition of formal and informal institutions does not make sense and needs to be expanded to include intermediate levels of formality and the transition from one to the other. The best starting point may be the analogy of hard and soft budget constraints. As with hard and soft budget constraints, we can claim hard and soft institutional constraints when constitutional and legal constraints (for example, the enforcement of property rights) exist at central government level, but their implementation is subject to local discretion with only limited possibilities to appeal to higher authorities. When local authorities are able to assume authority over aspects of enterprise operations without a legal basis, simply on an informal but nevertheless authoritative basis, or when local Communist Party cadres can override formal government institutions without facing negative sanctions, we might call these rules 'semiformal'. The authority of these political actors is not strictly formal in the sense that functions they assume, for example in local real estate development, may not actually be defined as local government tasks. On the other hand, their authority is not informal, because they are a constituent part of local governance. Nor is their *modus operandi* a hybrid one, because it has its own institutional logic when in operation. This wide spectrum of formality enables localism, social embeddedness, and organizational choice to structure China's economic institutions. Institutional architecture helps us to formulate an institutional complexity which is not envisaged in standard Western accounts of formal and informal institutions.

The standard Western perception of China's institutions rests on political assumptions, which do not necessarily apply to China's economic institutions. One such preconception is the predominance of the central state and its constitutional authority to define institutions at the local level. Another preconception is that social and political embedding of institutions occurs at central level, i.e. the notion that legitimization is a prerogative of the central state and transferred down to local state levels. A third preconception is that the organizational form of economic actors is seen to be the firm. These preconceptions are shared and enforced by official Chinese accounts which tend to focus on the country's formal institutions and the central political set-up. For China's local economies, where the majority of enterprises are found, this framework needs to be

reconsidered. We argue that policy signals and toleration of local diversity are important institutional inputs by the central state.

How misleading national laws or the national Constitution can be as indicators of institutional change is illustrated by the issue of formal private ownership rights. From a legal perspective, Western observers agree with the official Chinese view that China's thriving market economy has no or limited protection of private property rights. Indeed, up to 2004 private property rights were neither guaranteed neither by law nor by the Constitution. Yet this does not mean that property rights were lacking. As a result of gradual privatisation, property rights protection matters most at the operational level of enterprises (Oi 1995; Walder 1995; Krug and Hendrischke 2007), where local governments depend on increasing revenues. Being able to set privatisation policies and to lease out local economic assets, they had the means and incentives to protect well-performing local firms by offering them contractual security on an informal basis. In other words, the Chinese case does *not* prove that property rights are unnecessary for the development of a market economy. *China's example proves that property rights protection does not need a strong central state, but can be achieved by formal and informal coordination and interaction between local economic and political actors.* The weak formal protection of property rights is reminiscent of property privileges and echoes findings from different environments that property rights protection and contractual security do not need a strong central state (Dixit 2004), but can be organized by communities (Ostrom 1990), social groups (Greif 1993; 1998), or via private ordering (Ellickson 1991; Milgrom *et al.* 1990; Williamson 2002). The claim that ownership in China is unprotected refers to actual *legal practice* at local level rather than to local institutional practice, as the legal perspective disregards informal or semiformal protection of property rights. In short, a large part of China's institutional reality is not immediately obvious. In particular, informal and semiformal links between private economic actors and local authorities as well as links between local government agencies and higher layers of authority are not represented by official accounts.

At local level, central authorities give way to informal institution building that involves local economic, political and social actors. In economic analysis, the local state builds and protects institutions such as property rights not as an agent of the central state, which issues and codifies formal rules, but based on economic self-interest and local purposes. In this institutional set-up, local Communist Party cadres play a crucial role in mediating between central and local institutions and between local economic and broader societal interests. In their economic role, they are not tied to ideological prescriptions or the rigid formal government processes, but have sufficient authority to make credible commitments in the interest of strong local economies. Their presence and economic role is the strongest argument for differentiated institutional analysis.

As a consequence, China's central state does not have a monopoly on institution building, and economic institution building at enterprise level is not primarily defined through the Constitution. Devolution of institution building (as described in the Fiscal Federalism model) to the local level has important consequences for the national unity of economic institutions. It rests less on a formal conformity than on an informal political consensus maintained by the Communist Party which as the inheritor of long-standing institutional practices is an active contributor to local economic policies. The Communist Party maintains a political consensus that drives economic policies and is able to accommodate local differences in economic policies and institutions. Local differences emerge through the local embedding of institutions with the active involvement of local Party organizations. In terms of process, local economic institutions in the first instance evolve endogenously and take exogenous influences (including central policies) only as a frame of reference. More specifically, local institutions evolve through coordination between economic actors and local social and political agents.

This institutional set-up necessarily impinges on organizational forms, in particular the structure of local enterprises. Local entrepreneurs do not have the constitutional and legal back-up that enables them to concentrate on the market alone. Instead, *they face the commercial market as much as the institutional market* (Krug and Polos 2004). Both require entrepreneurial attributes in terms of financial, social and human capital, alertness

and creativity. Thus the attributes identified in the literature on competence building (e.g. Teece and Pisano 1994; Dosi *et al.* 2000; Langlois and Foss 1999), but also part of the research agenda on yardstick competition (Besley and Case 1995; Belleflamme and Hindriks 2005), apply equally to Chinese entrepreneurs, but evidence suggests that interpersonal coordination is better able to take care of their tasks than individual action. As was shown above, this type of interpersonal coordination can be modeled as networks which can assume different legal and organizational forms in response to different or changing institutional environments and in response to different organizational capabilities.

*Regarding localized institution building and informality as a matter of degree rather than part of a formal-informal dichotomy* raises several questions when it comes to modeling the institutional architecture:

- (1) *Causality.* Do localism and local social capital lead to a specific form of organizational choice, or does organizational choice lead to localism? The Fiscal Federalism model (Qian 2000) suggests that localism and jurisdictional competition predicate organizational choice; yet studies which focus on behavior of firms indicate that social (and financial) capital engender localism (for an excellent study of the foreign trade sector see Huang, 2003). In other words, the institutional constraints defined by Fiscal Federalism are either not rigorously enforced, or “weak central government” is in fact a euphemism for local autonomy and diversity which require other models for analysis. The answer to this questions is related to the issue of
- (2) *Hierarchy.* The relationship between sub-provincial localities (including local business systems), superior political and administrative entities and the central government is under-researched. For example, is the observed diversity in business systems and organizational forms the result of under-institutionalized, ineffective principal-agent relations in need of better management and management tools? On the other hand, is there a lack of consensus building in a non-democratic environment (where constitutional separation of powers and universal suffrage are missing)? For China, rent seeking by business communities or strategic alliances

between firms and local politicians (acting as lobbyists) fail to explain competitive dynamics and economic growth, and additionally clash with the Fiscal Federalism model. Political science models of multi-layered government are useful tools for political markets (mainly in Europe), but fail to explain how this form of institutional architecture could emerge in China. In short, rent-seeking approaches dismiss too many political factors, while multi-layered government models dismiss too many economic factors as explanatory variables.

- (3) *Replication.* Tradition or remembered (business) routines draw attention to the fact that the expected functional value of institutional alternatives need not be the decisive factor in institutional choice. If two alternatives result in identical effects, such as expected returns, then *persuasion* or *appeal* might be the additional reason for overcoming inertia or indifference. This type of (supplementary) appeal, whether remembered or replicated, can explain organizational and institutional variety (Aldrich 2001). In China's case, there are obvious historical parallels between contemporary and traditional forms of local administration and local autonomy to be explored by evolutionary theory.
- (4) *Scale.* Depending on the chosen unit of analysis, different outcomes are arrived at. Focusing on the aggregate level or central state policies points to changes in incentives and a larger opportunity set to which firms and entrepreneurs systematically respond. Focusing on the firm level though, points also toward organizational capabilities and strategies that lead to new organizational forms and institutions. Likewise, while the analysis of institutional change over time stresses the interplay between informal and formal constraints, specific institutions are seen as hard constraint from the individual firm's perspective irrespective whether formal or informal. In short, the problem of scale is also connected to the kind of economy one attempts to explain: the official/formal or the total economy. The analysis of the informal sector is more complicated, and time consuming; and requires research methods, which are not part of the general tool kit in economics. Yet, the effort to apply alternative methodologies, such as institutional game theory, interviews or "analytical narrative" (Bates 1998; Greif 2006) seems a low price to pay for the additional insight and ability to predict future conflicts.

These questions point to the research agenda which is only emerging and requires more detailed research in newly defined areas. However, even with these large and open questions in mind, certain conclusions seem justifiable even at this early stage of research.

### **Conclusion: Expanding the research agenda**

From an institutional perspective, four findings contribute to answering the puzzles identified earlier. First, entrepreneurs and networks are not recipients of but also agents initiating institutional change when they choose and agree on organizational forms and business practices which become entrenched first at the local level. The strategic management of tangible assets such as access of information and political connections generates firm-specific values; differences in organizational forms of firms therefore cannot be reduced to different transaction costs alone. They also indicate different organizational capabilities.

Second, without institutional analysis China cannot contribute to our understanding of “culture”. This does not mean that culture does not play a role. Differences across China reflect the effects of fiscal federalism, different organizational capabilities of firms, local government agencies and the cultural heterogeneity. Only by first identifying the features of local institutions can we expect insights in the interplay between “culture” and entrepreneurship, choice of organizational forms and strategies of firms.

Third, the reforms granted local government agencies regulatory power and direct access to tax and other revenues in return for support and implementation of the general reform course. Different localities used this leeway in different ways depending on their local resource base and interaction with the new business community. The competition between different jurisdictions demands attention in particular with respect to the negative effects of vertical (centre versus local) competition and the collaboration



between business communities and local government agencies. Principle-agent or patron-client relations co-exist with collusion of interests better modeled as strategic games.

Fourth, to acquire a comprehensive picture of China's institutional change requires overcoming the informal/formal institution dichotomy by conceptualizing what we called *institutional architecture*. Dismissing institution building initiated by firms and local government agencies via strategic political management leaves a large number of transactions and business relations unexplained. By integrating informal institution building, the diversity across China finds an additional explanation. Moreover, informal institution built on strategic cooperation between firms and networks also work as effective tools for softening formal constraints and for establishing alternative (hard) constraints. So long as organizational capabilities offer firm- and network-specific value and high revenues for local government agencies, local business systems reflect "alignment of interest" rather than politically defined "authority sharing".

All in all, on the conceptual side China makes a compelling case for combining an institutional perspective with dynamic capability approaches as this allows endogenizing politics, when it is no longer reduced to constraints and transaction costs. Analyzing firms and political actors and their dynamic organizational capabilities further proves them to be initiators of institutional change. Empirically, China makes a compelling case for taking firms and political actors at the local level as valuable sources for information, in particular with respect to informal institutions and institution building. Empirical research in China further suggests to embark on cross-case study analysis for identifying systematic features across sectors and localities, which once identified are open for systematic hypothesis testing.

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