CHINA INCORPORATED: PROPERTY RIGHTS, PRIVATISATION, AND THE EMERGENCE OF A PRIVATE BUSINESS SECTOR IN CHINA

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Abstract	The development of entrepreneurship and a private business sector in China pose various challenges to analysis. On the one hand, neo-classically based New Institutional Economics aims to find evidence that long-term investment and long-term commitment in and around firms can not be expected without deeply entrenched and state guaranteed private property rights. On the other hand, empirical studies within the China field concentrate on the political processes, in particular the interaction between the central state and local governments, at the danger of neglecting market forces, economic interests, and economic problems at stake. The empirical study on which the following is based took a different path by using a set of framing assumptions.	
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China Incorporated: Property Rights, Privatisation, and the Emergence of a Private Business Sector in China

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I. Introduction

The development of entrepreneurship and a private business sector in China pose various challenges to analysis. On the one hand, neo-classically based New Institutional Economics aims to find evidence that long-term investment and long-term commitment in and around firms can not be expected without deeply entrenched and state guaranteed private property rights. On the other hand, empirical studies within the China field concentrate on the political processes, in particular the interaction between the central state and local governments, at the danger of neglecting market forces, economic interests, and economic problems at stake[1]. The empirical study on which the following is based[2] took a different path by using a set of framing assumptions.

Firstly, it is assumed that in the course of the economic reforms firms became crucial from as early as 1983/84. It is as much the interaction – competition or cooperation – between firms as the interaction amongst all firms and their political environment that shapes the emergence and development of the private business sector.

Secondly, the official Chinese typology of enterprises will not be used. Instead the economic concept will be employed which defines ownership and autonomy according to risk taking and claim to residual income.

Thirdly, official statements regarding enterprise development and the role of administration are used only after they could be verified through interviews with enterprises.

Finally, the empirical study, based mainly on interviews in Zhejiang province in 2000/01, does not claim validity for its findings beyond the provincial borders. Provincial politicians, if not lower level (county, village) leaders enjoy considerable discretion in implementing reforms. Thus, different forms of private entrepreneurship can reflect different forms of implementation. Yet, such differences can also reflect different local cultures and development trajectories within China. It is for this reason that the research agenda of which the following is a part aims at a comparative analysis of four or five provinces[3].

Subsequently, the general question about Chinese entrepreneurship becomes localised in "What did Zhejiang province do to facilitate private entrepreneurship, the working of competition, and what ultimately turned the province into a success story?" The paper will proceed as follows. After the description of the political process that accompanied the development of the private business sector (Section II), some empirical findings will be presented in the form of "cases" that illustrate the emergence of different forms of firms, more specifically, why the family firm disappeared, how collective enterprises (via management buy-outs) were privatised or corporatised; and how (official) stake holders became shareholders (Section III).

Some tentative interpretations of the problems of family firms within the network-capitalism of China will be offered (Section IV). In the final part (Section V), the significance of networks will be elaborated. The conclusion will put forward some general thoughts on the use and importance of the empirical findings presented in this study.

II. The formation of property rights for private enterprises [4]

Zhejiang Province has played a leading role in the privatisation of enterprises since the early 1980s when the 'Wenzhou Model' was first propagated[5]. Seen in hindsight, the 'Wenzhou Model' was an early form of privatisation that was based on capital accumulation in a family and village environment of small and not professionally managed enterprises. Many respondents during the interviews mentioned that they went through a 'Wenzhou phase' in the 1980s. They associated this with under-capitalisation and the involvement of underqualified family members in the running of their enterprises. The first phase of professionalisation for these enterprises began in the late eighties with the promulgation of the standard regulations for shareholding (gufenzhi guifan tiaoli). The standard regulations were the first step in enabling enterprises to define property rights and separate collective and private enterprise shares. The impact of these regulations was initially restricted by the economic recession of the years from 1989 to 1991, which reduced business for many small enterprises or forced them to close down. The standard regulations were a national policy, which according to the interviews, was implemented at local level more in the form of recommendations to enterprises willing to participate in this transformation, rather than being enforced across the province as a compulsory measure. Shares defined by the standard regulations did not constitute legal titles for the owners. The ratio between private and collective shares allowable under these regulations was flexible and could lead to de facto privatisation, dependent on the local authorities. One of the respondents reported that in 1989 he was able to secure an 89 per cent share in a collective enterprise that he had built up in the preceding years. Nevertheless, this enterprise retained its status as a collective until 1998, when it became incorporated as a limited liability company and the owner legalised his personal share while increasing it to 96.6 per cent. Other respondents in comparable situations reported that they had to wait for years before their local authorities allowed them to formalise their private shares, irrespective of the fact that their shares in their enterprises were recognised at an informal level in form of a ‘private’ contract with local authorities.

During the next phase from 1992, enterprises were offered the chance to convert to a limited liability structure in anticipation of the Company Law which was still under consideration by the National People’s Congress in Beijing and only came into force in 1994. This anticipation of the Company Law was in effect a further clarification of ownership structures aimed at separating collective and private shares. According to the interviews the registration of shares under this policy did not have a legal basis, but was implemented by local authorities in preparation for the Company Law. Compliance with these new policies depended on local authorities, which could determine the number of enterprises participating as well as the maximum ratio of private shares. Private shares could be quite high.

When the Company Law was promulgated in 1994, provincial and local authorities supported its implementation as a province-wide policy. In Zhejiang, the separation of collective or state-owned and private shares under the new law happened faster than for example in Shanghai or Beijing. Respondents reported that local authorities, for example, requested enterprises under their jurisdiction to convert to limited liability companies without, however, enforcing any strict limits on the volume of private or public shares. Until the end of the 1990s, enterprises were left to decide how to divide shares between different forms of owners. While improving property rights, incorporation under the Company Law did not necessarily lead to privatisation in the sense of guaranteeing a majority for private shareholders. The enforcement of the incorporation under the Company Law differed locally. Respondents in one of the localities visited stated that while their local government supported incorporation, private shares in their locality were generally not allowed to exceed 35 per cent. Yet, it is noteworthy that with the implementation of the Company Law, the firm as a legal person became the owner of the firm's assets[6].

A further move towards privatisation and confirmation of private property rights was made in 2000, when provincial authorities propagated a ‘deepened system reform’ (shenhua gaizhi) for the years 2000 and 2001. This reform aimed at reducing all public enterprise shares to less than 50 per cent, effectively giving private entrepreneurs a majority share in local enterprises. At the time of the interviews, the related reforms had not been concluded. In one locality, they involved a number of smaller enterprises already operating as quasi private enterprises, although their managers’ shares were still kept at a maximum of 35 per cent by the local government. All these enterprises had drawn up transition plans, which generally prescribed a probation period of one year for the top managers who upon successful completion would gain a majority share in their enterprise.

The active implementation of the Company Law was only one aspect of the support extended to private enterprises by local state institutions which guided their transition to privatisation. In addition, the province encouraged local institutions to extend legal security to other areas of government activity. One example mentioned by respondents concerned new regulations for the sale of public land introduced in 1999. Public land had been under the control of local governments or village communities which had used the sale of land, or more precisely, the sale of long-term usage rights, as a way of accumulating capital for setting up local enterprises. Collective enterprises with no access to bank finance often relied on this method exclusively. During the nineties, this became an impediment for the development of private enterprises, as local communities tried to maximise their cash revenues from land sales at the cost of expanding private enterprises in need of new industrial sites. In 1999, a general restriction was introduced when all land sales by communities had to be conducted through public bidding under the supervision of local land administration authorities (tudi guanli ju).

General legal protection of private enterprises was also improved through protecting them from corrupt officials. Again, local regulations were issued that threatened officials of administrations in charge of private enterprises with penalties or dismissal if they were repeatedly found enjoying banquets or other invitations by the same enterprises. The official hold on a firm's cash flow was better monitored; to redirect cash for financing bureaucratic consumption was punished[7].

In short, while private property rights became officially acknowledged when firms became legal persons, local authorities honoured property rights even before private shares became legally binding entitlements. Likewise, local authorities could implement land and real estate markets by which land, formerly controlled by the state or communities, was turned into a transferable asset.

The Zhejiang example shows that local administrations can guide and support the establishment and protection of property rights for private entrepreneurs without the active corporate involvement of local officials that has given rise to the notion of local state corporatism. To understand this process, it is necessary to turn to the entrepreneurs themselves and the way they take up the economic opportunities created in this transition process.

III. From usage rights to corporate assets

One unexpected observation in this context was the exclusion of family members from shareholding and management, as established knowledge about Chinese enterprises in Zhejiang in particular and China in general would rather have indicated the opposite trend[8]. Admittedly, shareholding by family members during the establishment of enterprises was a common occurrence for many respondents. However, with the exception of smaller enterprises, such as restaurants, this does not suffice to define these enterprises as family enterprises. Firstly, in the case of all larger enterprises, capital contributions by family members were generally not made in the form of long-term equity capital, but rather on a short-term basis of two to three years and at interest rates of twice or three times the level of the going bank rate. As a source of enterprise finance, family members thus offered little advantage over business partners or friends. Another avenue for family members to become shareholders was through the requirement of the Company Law of a minimum number of two shareholders. Respondents agreed that these positions would generally be filled with trustworthy members of the core families who, however, irrespective of their family status, would only receive minimum shares to ensure that they remained at arm's length from enterprise management. In the view of respondents, the involvement of family members always implied the risk that they might demand a say in the management of the enterprise on the basis of their capital contribution. Consider the following example:

Case 1: The family business.

The Garden of Manifold Pleasures is one of those new Limited Liability Corporations whose directors and shareholders feel slightly overwhelmed by their new titles and authority. In 1984, when Mr. Zhou Weiming and his wife were assigned a building and some surrounding space by the local street committee in Hangzhou Upper District (Shangchengqu), they had so little money that it did not even occur to them that they were dealing with something that might be called capital. The family's cooking skills attracted customers and as their restaurant slowly grew, they were able to make some savings and invest in new equipment. The neighbourhood committee was not much interested in their commercial dealings as long as the Zhous created employment only for family members. This changed as Mr. Zhou slowly increased his staff from the original eight family members to 52 people recruited from the neighbourhood. The committee now provided more space and received payments from the restaurant. At the end of this process, Mr. Zhou acted as the owner, claiming net profit, while the neighbourhood committee received a nominal rent from the restaurant.

When local policies required that the street committee enterprises be converted into Limited Liability Companies, Mr. Zhou solved the problem by asking his two sisters to become silent shareholders. Together they received a share of 30 per cent, while Mr. Zhou and his wife took a share of 60 per cent, thus fulfilling the requirement that corporations needed at least two shareholders. Mr. Zhou could have increased his majority to 70 per cent, but he felt it wise to include the street committee with a ten per cent share. He made this offer to the Street Committee in view of its original contribution in form of land and the building and "in order to keep the good relations going". Profit is distributed according to shares, while all major decisions are made by him (and his wife).

Mr. Zhou is concerned about local competitors. They have an impact on his business and he has to keep an eye on them. Competition forces him to constantly upgrade his restaurant. He insists on relying on his personal savings for investment. The only instance when he used bank finance for an investment was when he bought a new Karaoke equipment. However, the relatively small sum was more than covered by the fixed-term deposit he kept in the same bank. Mr. Zhou does not think that he could go bankrupt, as long as the restaurant remains small and does not incur any debt. In the worst case he can "return to unemployment". Any expansion would mean to use "outsiders", i.e. people not known to him whom he would not trust.

The important point to note here is that it was the Company Law that provided the incentive to ask family members to become shareowners in the incorporated firm. Respondents agreed that shareholder positions would generally be filled with trustworthy members of the core families who, irrespective of their family status, would only receive minimum shares and no management rights. The formal aspects alone, of family members having made some initial investment or accepted to function as silent shareholders, or even a low-level employee, do not fulfil the definite requirements for classification as family enterprise[9]. Some respondents explained that they had taken preventive measures to ensure that family members remained excluded from management functions after their retirement. Their justification was that family members were generally not qualified for management tasks. The collective memory of the many failed family enterprises that had to be taken over by functioning enterprises during the recession of 1989 to 1991 in order to maintain employment might have served as a lesson for those entrepreneurs who survived the crisis.

This indicates a special resource constraint family firms may face. Their ability to expand beyond the local community is less due to a lack of finances and connections (social capital), but rather to a lack of managerial skills within the family[10].

The importance of managerial skills is also manifested in frequent management buy-outs. Management buy-outs are a little documented form of privatisation in China which actually preceded the legalisation through the Company Law. Like other forms of privatisation, they often evolved from an informal contractual basis and subsequently utilised the Company Law for conversion to private ownership, as the example of Pump Factory Ltd. in Zhuji near Hangzhou shows.

Case 2: Management Buy-out

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

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

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

Once more, privatisation and the acknowledgement of property rights can be shown to be the outcome of local politics rather than of national legislation. This form of privatisation depends on social capital and networking between firms and local authorities.

Social capital can instigate entrepreneurial activity that precedes the establishment of enterprises at a stage when property rights cannot even take effect. This social capital is generated within networks. The following case illustrates the flexible functioning of social capital in a network that led to the formation of a private company. In the end, this network venture included none of the original stakeholders, who had planned and set up the enterprise.

Case 3: Setting up a firm through social capital

In the case of the Street Lighting Factory Ltd., the object of privatisation was not a tangible asset, but rather a business opportunity conceived by the original state-owned enterprise and the local Bureau of Industry and Commerce. They could have expanded their own existing structures for this purpose, but instead chose to privatise. For this purpose, they activated a network of contacts to find a potential private entrepreneur among their own ranks who would be able to organise the supply of high-tech components to China's most advanced producer of street lighting. For the respondent this offered a chance to start his own company. Arguably, he faced considerable risk, because on offer was not a binding supplier's contract, but simply the reasonable chance to enter a lucrative market, provided that he could meet challenges of new technologies, quality control and reliability. There was the chance that by using his old connections with the state-owned enterprise, he might develop business links with their joint venture partner, a major multinational corporation.

The respondent decided to face the challenge. As a physics graduate of Shanghai's Fudan University in the 1960s, he had had a model career as a technical cadre in his home city's industrial administration in Zhejiang. Rising through the technical ranks, he had become factory director of a local specialised glass factory from 1982 to 1985. From there he had moved to the local industrial and commercial administration to take charge of general administration, personnel and enterprise administration. His career change to private entrepreneur came unexpectedly through his personal relations to the state-owned enterprise, a well-established producer of street lighting with a history of over eighty years. In the seventies, this enterprise had bought semi-finished products from the respondent's factory. In 1993, the state-owned enterprise required for its joint venture a supplier of mercury vapour street lighting components and contacted local industrial administrations and the respondent's former factory in search for an entrepreneur who would be able to set up a new enterprise to look after this business opportunity. In the end, the choice fell on the respondent after his local industrial administration and former colleagues from his factory recommend him to set up a private company.

The respondent required investment funding of 500,000 Yuan of which 400,000 Yuan were for equipment and 100,000 Yuan for running costs. He and his deputy, his former chief engineer from his time as a factory director, contributed 60,000 Yuan each for their individual shares of together thirteen per cent of the registered capital. Five smaller investors who were interested in employment with the company acquired another fourteen per cent. The bulk of sixty per cent came from a local private entrepreneur who had set up his own electrical goods company in 1988 and who interestingly enough claimed no position in the management. This ownership structure set up in 1993 has remained unchanged. With the exception of one, the small investors have left the company, but retained their shares. In 2000, the company registered as a Limited Liability Company, a move that prompted clarification of property rights.

Today, the majority investor holds the position of Chairman of the Board of Directors. The Board discusses and decides all major issues, such as major investments, technological innovations, daughter companies and large bank loans by voting according to shares. While this gives crucial powers to the majority shareholder, the operational side of the business is the sole responsibility of the respondent who is the general manager. The distribution of profit is unusual. Sixty per cent are re-invested; out of the remaining forty per cent the respondent as general manager receives half as his dividend. This exceeds by far the sum he would be entitled to on the ground of his thirteen per cent chare of registered capital. Again, this additional benefit needs to be seen as a premium for product ideas, managerial skills in perceiving business opportunities, and his ability to turn old contacts into business relations, as the following explanations given during the interview may show.

During the start-up period the company actually did not receive any orders from the Shanghai Joint Venture. On an informal, personal basis the management was able to obtain technical information, which was relayed through a network of contacts of people who in the past had worked for the Joint Venture and maintained links with its technical staff. Initially, the new company only managed to sell to smaller domestic clients in Southern China and to some Middle Eastern countries. By 1995, the quality of their products had reached a level where the Shanghai-based Joint Venture finally accepted them as a supplier. From then on, their production expanded rapidly. By 2000, sixty per cent of their production was sold to the Shanghai Joint Venture.

Relations with their Shanghai client have now become so close that the company is investing in new technologies in order to keep pace with technological innovations by the Shanghai client who provides technical know-how and information required for changes in products and quality. The joint effort led to new products that are expected to open the

South Korean market and further export opportunities. In 2000, the company obtained its first medium-term bank credit, to be paid back within three years, to finance the required investment in research and development.

To note here is that this profitable private firm is based on a public-private network that originated in the former state sector[11]. The network in this example has a very specific function in providing input for which there was and still is not yet a market in China. Such non-tradable resources are not limited to state controlled input, but include venture capital, technical know-how, managerial talent and potential access to clients (or reputation).

Furthermore, the case is remarkable for the interplay between the network and the institution of property rights. While participants of the network used their social capital to devise the new enterprise, they relied on institutional support, specifically the property rights provided under the Company Law, to create a spin-off that had its own corporate identity and operated under market conditions.

A third noteworthy feature is that a group of investors or a network can establish private property rights by the way of incorporating companies.[12] Regardless what the actual share in corporate (financial) capital, as long as there is a consensus of all stakeholders, and ownership claims are not disputed, they are able to establish private property rights. The investiture of the general manager as second major shareholder and major dividend recipient once more indicate the extent to which managerial talent and social capital is rewarded in the present business environment of China.

The apparent absence of family enterprises on the one hand and the ubiquity of networks and their obvious ability to take on functions that are generally assumed to be the prerogative of family networks on the other, make it tempting to speculate about functional links and transitions between the two. Before turning to this topic, let us first take a closer look at the entrepreneurial role of the family in a broader framework.

IV. The family as a special form of network.

While the existing literature on the structure of the Chinese firm strongly emphasises the role of the extended family in the establishment of new firms, as well as at the core of the private sector in general, the striking empirical result of surveys in Shanxi, Zhejiang and Jiangsu indicate that the notion of the extended family as the major basis for private enterprise will not survive extended empirical scrutiny[13]. This unexpected outcome from interviews in these provinces justifies a more detailed look at the data and the underlying variables. The tables below result from surveys in these three provinces.

Tab. 1: Ownership: Who owns the firm? (v15)

Answer	Frequency	Percent
respondent alone	18	25,4
respondent's family	9	12,7
respondent with less than 6 friends	13	18,3
group of private investors	13	18,3
mix of answers 1 – 4	3	4,2
collective village	2	2,8
mix of collective and 1 – 4	3	4,2
state firm	9	12,7
Confused	1	1,4
Total	71	100,0

At first sight, the data set seems to be dominated by firms established and managed by one individual: the Schumpeterian entrepreneur. The second largest group are firms established by friends. There is reason to add the category of private investors this group, as these were also friends or colleagues in most cases. Thus, responses to this general question suggest that entrepreneurship in China is built on networks of friendship rather than on family ties.

One could argue that even if family ties were not evident in the establishment of the firm, they still might serve as a surrogate capital market in that the institution of the extended family allows to pool savings for one entrepreneurial family member to rely on. It was therefore specifically asked if the family functions as a source for accumulating the initial endowment of the firm. As Tab. 2 shows this was the case in only twenty seven per cent of the cases. Again friends come in first, in particular in the 1980s and early 1990s when banks were not yet willing or able to lend to individuals.

Tab. 2: Was the family a source of funds for capital assets (i.e. land, plant and machinery, etc.) when the firm was first set up? (v34)

Answer	Frequency	Percent
yes	19	27,1
no	51	72,9
Total	70	100,0

While 47.8 per cent of respondents answered that family connections were not important for the success of a firm (v 115), the importance of friends is reflected in the next questions, which asked who the entrepreneur would turn to for support in case of economic problems.

Tab. 3: In the event of a serious problem or an emergency, which individuals or organisations would you expect to come to your help?

Answer		Frequency	Percent
Banks		**36**	**52.9**
	1st mentioned	32	47.0
	2nd mentioned	4	5.9
Friends		**11**	**16.2**
	1st mentioned	6	8.8
	2nd mentioned	5	7.4
Local government, Party, "state"		**5**	**7.4**
	1st mentioned	4	5.9
	2nd mentioned	1	1.5
Industrial & commerce associations		**2**	**2.9**
Shareholders		**2**	**2.9**
No need		**2**	**2.9**
Nobody		**2**	**2.9**
Company in same sector		**2**	**2.9**
Mother company		**2**	**2.9**
Employees		**2**	**2.9**
Court		**1**	**1.5**
Family (Family members)		**1**	**1.5**
Total		**68**	**100,0**

Finally, when asked about the general importance of the family for business success, the following answers shed a striking light on the demise of the (extended) family as an economic actor. Only five out of forty four agreed (or slightly agreed) with the statement "Family connections with a wide range of people are crucial to the success of the firm."

Tab. 4: Family connections with a wide range of people are crucial to the success of the firm. (v248)

Answer	Frequency	Percent	Cumulative Percent
strongly disagree	10	27,8	27,8
disagree	15	41,7	69,4
slightly disagree	2	5,6	75,0
not sure	4	11,1	86,1
slightly agree	3	8,3	94,4
strongly agree	2	5,6	100,0
Total	36	100,0	

These empirical findings cannot easily be dismissed and should be seen as a challenge for further analysis. One obvious question in future studies would ask if the extended family as an entrepreneurial core has withered away in the People's Republic of China, and if so, what caused this development. To claim that this is due to the global modernisation process and point to the examples of other countries misses the point, as studies on Overseas Chinese communities have convincingly proved that the Chinese form of loose ties within the extended family can smoothly adapt to a working market environment[14]. A socio-political argument might focus on the effects of the Cultural Revolution that left no family untouched. If as a general experience a large number of families have been split on political grounds, a drop in the general level of trust could be expected. Yet, the extent to which such a drop in the level of trust within families leads to other, substitute forms of co-ordination depends on available and known alternatives. As the empirical findings indicate, friendship seems to be a close enough surrogate for the extended family. When asked to specify friendship links, the respondents named three groups: childhood friends, friends from the military service and friends from college or university. All three groups served as the focal point in forming networks. It is worth mentioning that Party membership might have been appreciated, yet was not a decisive factor in network formation.

Opposed, or rather complementary, to this *trust* argument[15] is an argument that focuses on the *resource-base* of the family. Even if extended family ties had survived the political and social changes during the first decades of the People's Republic, the resource base of families after thirty years of Communist rule (preceded by decades of civil war) was certainly low when economic reforms started in the 1980s. The narrow resource base is not limited to financial capital but includes all forms of human and social capital. Thus, one of the strengths of the (old) extended family, namely that its access to a large pool of differing talents, education and personal relations, was lost[16]. Instead, friendship links built on army ties or university education offered comparatively better prospects, considering that universities and the army have been two of the few broad institutions outside the Party where people from all parts of the country and different backgrounds could meet. One of the major problems facing successful firms is how to expand from local origins into the national market. As the interviews indicate, this was an area where the reliance on friends who had returned to their home provinces proved much superior to relying on family members who most probably lived in the closer surrounding.

The comparative advantage of networks built on friendship and common interest will only work if the internal governance of the network shows similar or lower transaction costs than the governance of families in regards to acceptance of norms of reciprocity and acknowledgement of mutual obligations. As the interviews seem to confirm this, one could reverse the question and ask if the family should not be seen as a special form of network built on trust among a predefined group of members, albeit not to the exclusion of economic reasoning. This would deprive the family of its exclusivity and make it one network amongst others among which the entrepreneur has to make a choice.

In China's institutional environment, firms depend on networks for survival and expansion. These networks cannot be expected to disappear completely if and when functioning markets and legal process will have been established in the process of further marketisation. At the firm level the networks show up in the form of shareholding, cross-shareholding or "holdings". At the level of industries they manifest themselves (if they do not prefer to remain invisible[17]) as chambers of commerce, business associations, or simply groups of people sharing similar backgrounds.

V. Some findings: Networks and Firms

The establishment of private property rights in China has been an incremental process from the introduction of usage rights to the acknowledgement of individuals (natural persons) as owners of capital assets and from collective rights to the establishment of firms that as legal persons own corporate assets. Rather than on national legislation, the speed of this process depends on local politics, that is, the operation of local networks. It seems too easy to point to one group, say, Communist Party cadres, the village or township, the Industrial and Commercial Bureau, let alone the family, as natural partners in the formation of networks. A more systematic analysis of the background of firms and the prevalence of state-private networks points to the economic value of networks.[19] Networks are formed and maintained via entry and exit of individuals. They provide firms with at least one of the following three 'services'.

(1) Both private property rights *protection* and contractual security are generally collective goods provided by local state agencies in charge of the enforcement of liability and contractual obligations. Weak state enforcement can be complemented by the internal enforcement mechanism of networks which have social sanctioning mechanisms, such as loss of reputation, "hostage" taking or ostracising individual members to their avail[20]. Uniquely for China, and in contrast to more generally known cases of patronage systems[21], local state agencies can be part of networks in which they cooperate with other partners to *establish* private property rights. In this, they are undoubtedly helped by national legislation on which they can rely to legally sanction their actions, but the incorporation of companies needs to be approved and implemented at the local level in the first place. The required initiative and active participation by local government institutions in this process is secured through their participation in local networks.

To conclude from this that patronage networks would disappear once national law enforcement agencies will function better seems premature, however. Most networks do not limit their 'range of services' to protection but also offer access to non-tradeable input.

The *non-tradability of many resources* is certainly one of the most severe constraints in the development of firms and the private business sector. It explains, for example, why Chinese firms operating in insecure environments do not go for vertical integration or product diversification, but instead expand via investment into unrelated lines of production. A resource to which a firm happens to have access needs to be put to best use, whether this use adds up to a business core or not, as costly intra-firm slack is to be avoided. The function of networks in such a case is to assist in a swap of idle or inefficiently used resources amongst its members. By doing so, the network can broker access too much needed assets, enlarging the resource base of its member firms[22].

In this case, too, we may conclude that better functioning markets, i.e. less state controlled input, will drive out networks. As likely as this is, in particular, if further marketisation is accompanied by better law enforcement, it does still not imply that networks will disappear.

The reason is that non-transferability is not limited to state control. Other hard-to-transfer inputs include (tacit) knowledge, business routines, and learning; in short activities which create positive externalities. In similar situations, Western market economies also respond by network formation, for which Silicon Valley is the best-known example.

(3) As the real option approach in capital markets has shown it is worthwhile for firms to *buy an option on assets*, such as patents, before relative prices are generated in markets which then decide on the execution of such an option[23]. Such "fishing for opportunity" strategy is what networks do in the case of the private sector in China. Once profitability of the use of an asset is perceived, but cannot yet be calculated, networks get an option. By doing so, they create a pool of different options available to different entrepreneurs or firms. Seen in this light, networks serve as learning platforms that allow failure of individual firms, as each individual failure helps to improve the calculation of future outcomes and stabilise expectations. Unlike private firms, networks are able to exploit these possibilities, as the sunk costs involved in individual failure can be counterbalanced by the gain from acquiring investment-specific knowledge.

All in all, these findings cannot come as a surprise to transaction costs economics. The use of the market in China is still a costly way for allocating resources and investing in new products or new sectors[24]. The results of the empirical study suggest that networks are less costly devices when it comes to better exploiting non-transferable input and exploring business or investment opportunities.

VI. **Conclusion**

Once in a while it is worthwhile to ask ‘is the fact a fact’, even in a theory-driven field like economics. This implies that instead of testing existing theories or searching for supportive evidence to well-known assumptions, the research design needs to be explorative. Consequently, other techniques need to be employed in order to generate data on which new ‘models’ can be built. For example, as for our purpose the State Statistical Yearbook of the People’s Republic of China is a political document structured according to administrative classifications rather than a collection of data structured according to economic concepts, it is of limited use only.

Empirical research in China needs to generate “raw data” that allow employing the analytical toolkit of modern economics. One device is to use interviews, questionnaires, and quantitative methods developed for analysing such data. Taking into account the time constraint most empirical research faces, such a procedure implies that the idea of dealing with large numbers and tools developed for this purpose has to be given up. In other words, economics has to move away from macroeconomics and econometrics toward other social sciences where such techniques are well established, like for example sociology and social psychology.

The use of *case studies* poses another problem. If case studies are to offer more than anecdotes, they need to be structured along conceptual terms, which allow subsequent repetition of the research design. The research agenda of which the findings presented here form a part distinguishes two periods and two techniques: There is first the pre-sample period for which the relevant data were gathered through open interviews. For the sample itself, data are generated with the help of a standardised questionnaire. While the latter technique is well established in the social sciences, the former is rather new. Therefore, a short description seems to be appropriate.

The interviews followed a method developed in Stanford for the analysis of the emergence and dissolution of firms and sectors (*industrial districts*, in Marshall's terminology). It is called *Event-History Design*[25] that aims at 'information on the exact times and character of all demographic events experienced over the lifetime of the organization (firms) in the set'[26]. The sequencing of events matters, as does the definition of events in appropriate conceptual terms.

In the empirical study introduced above, the events were entrepreneurship, i.e. the activities that precede the registration of a firm or the beginning of production, ownership and private property rights, diversification, and expansion beyond the local nexus[27].

The findings of the study suggest revising both the conventional view of China, and the conventional analytical procedures fore transition economies. The assumption of China as a homogenous culture is misleading, likewise the assumption that culturally determined behaviour dominates economic choice and decision-making. Chinese economic actors, too, employ an economic calculus. The quick dismissal of the notion of the family firm, which is seen as an inferior institution when compared to incorporated firms linked by networks, offers one striking example. This is not to say, however, that culture does not play a role. The ability to establish and maintain networks built on trust, reciprocity, and mutual obligations, is another equally striking example.

Moreover, the regional variations (or different 'cultures') within China might find their explanation in the different practices remembered and revived by locally entrenched networks and/or negotiated between firms and political authorities responsible for the implementation of reforms. As ample of empirical research has shown[28], it is the local leadership rather than national legislation which determines the pace of implementation. When it comes to explaining the variations in economic behaviour or economic development, any empirical study faces the problem that on the one hand these variations reflect different local business practises as remembered or negotiated, and on the other hand the variations might reflect a different stages in the time path of the reforms.

Whatever the cause in each single case, it is necessary to construct a more specific theory for transition economies that allows analysing the *context* in which the economic calculus dominates choice, and in which economic actors find it more promising to revive and employ other mechanism for individual choice, allocation and coordination.

Finally, the findings suggest that one should beware of falling into the *availability trap*. To interpret or re-interpret China's transition and economic development with the help of easily available general literature or statistics can be misleading. The opening up of China has resulted in a rapidly increasing literature in specialised journals, which deserves attention. The literature on networks or family business illustrates the point.[29]

This literature further suggests that analysis based on conceptual terms, i.e. taking China as a 'case', might offer additional and more fruitful insights than adopting the concept of 'Chineseness' for an analysis that confirms available information and merely adds additional supportive evidence.

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[1] Oi and Walder (1999; Parris (1996 S. 1); Solinger (1993, S. 256); Yang (1989, S. 31); Henriot and Lu (1996); Pearson (1994, p. 25); Wank (1995, p. 55).

[2] The financial support by the Royal Dutch Academy of Science and the Trustfonds of the Erasmus University is gratefully acknowledged, as is the support from the Australia Research Council through a small grant by the University of New South Wales, Sydney.

[3] Krug (2002a), Goodman (1999), Hendrischke (2002).

[4] The following is based on Hendrischke (2001).

[5] Nolan and Dong (1990), Liu (1992).

[6] Company Law, paragraph 2, art. 4.

[7] Shleifer and Vishny (1993).

[8] Boisot and Child (1999), Fukuyama (1995), Redding (1996a, 1996b), Wong 1985.

[9] See also Pistrui. (2001).

[10] A point also noted in the family business of Overseas Chinese, see Carney (1998).

[11] See also Lin and Zhu (2001), Nee (2000), Ding (2000).

[12] Park and Luo (2001), Wank (1996), Tsang (1998).

[13] The Shanxi sample of 1999 lists 27 interviews; the Zhejiang sample of 2000 comprises 26 and the Jiangsu sample of 2001 27 interviews. The data set based on standardised interviews thus includes 80 respondents. Including the open interviews of the preceding years, more then 140 life histories of firms are available.

[14] Hamilton (1996), Kao (1991), Whitley (1995), Yeung (1994), Yoshira (1988).

[15] Cheng and Rosett (1991), Menkhoff (1992).

[16] Eastman (1988), Freedman (1970).

[17] The best analysis so far is provided by Lever-Tracy. For Chinese firms in Australia, see Lever Tracy (1996).

[18] The best analysis so far is provided by Lever-Tracy. For Chinese firms in Australia, see Lever Tracy (1996).

[19] Luo and Chen (1996), Kao (1993), Tsan (1998), Xin and Pearce (1996), Hendrischke (2002).

[20] Coleman (1990), Nooteboom (1996).

[21] Gambetta (1993).

[22] Krug and Polos 2001. An evolutionary model which will elaborate on the funcitoning of networks will be presented at the INSEAD conference in Febr. 2002, see Krug and Hendrischke 2002. See also Luo and Chen 1996.

[23] Trigeorgis (1993).

[24] Williamson (1994), Qian (2000), Davies, Leung, Luk and Wong (1995).
[25] See Caroll and Hannan (2000), chap.5.
[26] See Caroll and Hannan (2000), p. 101.
[27] Other concepts not dealt with in the present study include trust, reciprocity, private exchange, transaction costs and networks. See Krug and Belschak (2002 forthcoming).
[28] Einfuegen Ordner Uni
[29] See references in the reference list for both topics.

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