ENTREPRENEURSHIP IN CHINA: INSTITUTIONS, ORGANISATIONAL IDENDITY AND SURVIVAL.

EMPIRICAL RESULTS FROM TWO PROVINCES

BARBARA KRUG AND HANS HENDRISCHKE

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Email address corresponding author	bkrug@fbk.eur.nl
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Abstract

The literature on transaction costs concentrates on established firms in established markets, while the literature on industrial ecology concentrates on new firms in given markets. It is contested in the following that the picture looks differently if the analysis concentrates on establishing new firms in new markets, such as e-commerce or the new private sector in the formerly socialist economies. A new market is defined by high uncertainty. First, the general knowledge of expertise in a society is low, so that young entrepreneurs find it hard, and costly, to acquire the necessary know-how. Second, institutions, might these be the law, business practices, or intermediaries, are poor and underdeveloped.

It will be argued that in China therefore entrepreneurship depends crucially on the ability to establish firms, i.e. to find organisational forms for business ventures that facilitate long-term business relations within and around a firm, that is to say, individual entrepreneurship depends on mechanisms for co-ordinating individual or organisational behaviour of firms. These mechanisms were lacking under socialist planning. The legacy of the planned economy was an environment of weak economic institutions in which state-socialist institutions uneasily coexisted with market institutions, and newness of private exchange added to uncertainty. In this environment, economic actors depended on collective action to create their own institutions, driven by the need to agree on rules of conduct in business relations and on sanctions against violation of these rules.

The study will concentrate on two essential components of (private) entrepreneurship. One is the search for organisational forms conforming to the situational constraints; the other is the formation of business practices that enable individual entrepreneurship to become a viable and sustainable course of action. In other words, we will attempt to show how the transaction cost advantage of organisational forms and co-ordination mechanisms can compensate entrepreneurs for the disadvantage they face with respect to the lack of clearly defined property rights.

Based on extensive fieldwork in two provinces where 100 firms were interviewed the study can show that

as predicted by approaches in industrial ecology both *experimentation and selection* were crucial in shaping the new private business sector; on the individual level the *performance-orientation* of Chinese culture allowed entrepreneurs to combine rational decision making with tradition.

Both factors can explain why for example the family in China but not in Chinese overseas communities is no longer the natural base for private firms, why networks are assessed by their expected performance, or why Chinese firm do not care about building up a core business.

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Entrepreneurship in China: institutions, organisational identity and survival. Empirical results from two provinces

Barbara Krug

Rotterdam School of Management

Erasmus University Rotterdam

P.O.Box 1738

NL 3000 DR Rotterdam

bkrug@fbk.eur.nl

Hans Hendrischke

Department of Chinese and Indonesian Studies

The University of New South Wales

Sydney 2052 Australia

h.hendrischke@unsw.edu.au

After twenty years of reform China's economic transition can claim to be a success story. Growth rates, diversification in domestic production and foreign trade, and, last but not least, China's entry into the World Trade Organisation have made China a major player in world production and trade. This certainly came as a surprise for those observers who were familiar with the economic situation in the middle of the seventies and remained unforeseeable for Chinese and foreign observers until the middle of the eighties. Credit is generally given to the pragmatic economic policies of the central government, but it is worth asking how Chinese entrepreneurship contributed to this turn-around. Comparing China with other transition economies, none of which can compete with the Chinese performance, adds to the uniqueness of China's economic development. After all, China, with the exception of Vietnam, is the only transition economy that has not yet established full private property rights. As economic theory claims and economic history has proven (North 1984, Greif 1993), private property rights are the *conditio sine qua non* for the emergence of private exchange, investment and functioning Markets. For the purpose of this study, China's economic development will be linked to the emergence of successful entrepreneurship in its private, or more specifically, non-state business sector. As argued elsewhere (Krug and Mehta 2002; Krug and Polos 2001; Hendrischke 2001; Qian 2000), entrepreneurship depends crucially on the ability to establish firms, i.e. to find organisational forms for business ventures that facilitate long-term business relations within and around a firm, that is to say, individual entrepreneurship depends on mechanisms for co-ordinating individual or organisational behaviour of firms. These mechanisms were lacking under socialist planning. The legacy of the planned economy was an environment of weak economic institutions in which state-socialist institutions uneasily coexisted with market institutions, and newness of private exchange added to uncertainty. In this environment, economic actors depended on collective action to create their own institutions, driven by the need to agree on rules of conduct in business relations and on sanctions against violation of these rules.

The study will concentrate on two essential components of (private) entrepreneurship. One is the search for organisational forms conforming to the situational constraints; the other is the formation of business practices that enable individual entrepreneurship to become a viable and sustainable course of action. In other words, we will attempt to show how the transaction cost advantage of organisational forms and co-ordination mechanisms can compensate entrepreneurs for the disadvantage they face with respect to the lack of clearly defined property rights.

Theoretical insights from industrial ecology (Hannan and Freeman 1989; Carroll and Hannan 2000), institutional economics (Caroll and Teece 1999, Williamson 1994; Whitley 1995), evolutionary economics (Nelson 1996; North 1984) as well as empirical studies describing the ongoing politically defined changes in the institutional constraints (Ducket 1998, Guthrie 1999, Nolan 2001) suggest a dynamic approach to formulating an *ex post* analysis of the development of the private business sector. *Experimentation* and *selection* are the two means that can be expected to set “defaults” for successful organisational forms of and co-ordination mechanisms among private firms. Successful is understood here in terms of the survivability of business ventures. The first part of the following considerations concentrates on a descriptive analysis of the business sector with respect to organisational form and interaction between firms. The attempt to present an ex post model of the institutional environment of Chinese private enterprise is a challenging one, as it requires to

- telescope events together, i.e. to compress time in order to present the main trends in over twenty years of developments;
- compress diversity in order to concentrate on systemic factors and meaningful concept ional terms, such as size, diversity on production, ownership, voluntary exchange, coercion, collaboration or competition.

This is only possible at the cost of a high level of generalisation and disregard for regional and local deviations from advanced practice found in the two economically most flourishing provinces of Zhejiang and Jiangsu (the institutional impact of Hong Kong on the neighbouring province of Guangzhou is not subject of this paper).

Experimentation can be seen at work in the private business sector in the changing configuration and new organisational forms of non-state firms. Selection takes place when some forms are discarded or pushed “to the margin”. Certainly one of the most surprising results is the “marginalisation” of family firms which set in once a family business expanded beyond its local nexus. With the state no longer in exclusive control of resource and input-allocation or income flows, firms and entrepreneurs started experimenting with different forms of co-ordination mechanisms, resulting in a multitude of different forms. At the present stage, the most remarkable mechanism for the coordination of resources and imposing of sanctions that has emerged from this process are *networks*.

The second part of this paper will attempt to explain why entrepreneurs and firms settled for a limited range of organisational forms and agreed upon a certain set of behavioural codes, while leaving other potential forms idle. Here, economic analysis was aided by the insights of cultural studies (Hofstede 1991; 1993; House *et. al.* 1999; Javidan and House 2001). The focus was on the selection criteria: Do economic actors choose a certain mechanism for its functional value or because it is the accepted "way" of doing business? In short, the question was, are networks or *guanxi* a culturally determined Chinese way of doing business or rather an effective institutional solution in the environment of weak institutions and uncertainty (see also Xin and Pearce 1996).

As will be seen further on, it is the *performance-orientation* in Chinese culture that makes it possible to combine economic and cultural values, and not seeing economic functionality and culture as mutually exclusive (Krug and Belschak 2002).

The empirical study

The models developed in this study are based on fieldwork by the authors. Secondary literature, in particular fieldwork by other social scientists, was used to check variations in forms and co-ordination mechanisms as well as the time sequence of the reforms (for example Lin and Zhu 2001; Nee 1989; 2000; Nee and Matthews 1996; Nee and Su 1990; Oi and Walder 1999; Parris 1996; Rozelle and Li 1998; Solinger 1993; Walder 1994;

Ding 2000; Pistrui, Huang, Oksoy Jing and Welsch 2001, Redding 1996; Smyth 1999; Wank 1996; So 2000).

Sample Selection

Two hundred interviews conducted during 1995-2001 form the background of what follows. While in the first few years only open interviews were executed, a standardised questionnaire was developed in 1999. Three provinces have been selected so far for the interviews, Shanxi in North China (Goodman 1999), Zhejiang (Forster 1997; Krug and Hendrischke 2001), and Jiangsu in Eastern China (Jacobs 1999). The latter two are particularly relevant for this study.

Data sources

Neither official classification systems, e.g. the State Statistical Yearbooks, which clusters firms according to administrative criteria, nor self-identification through company names or individual enterprise business cards provide meaningful or consistent information about the organisational form of firms. For example, the differentiation between urban and rural collective enterprises maintained by State Statistical Yearbooks for administrative reasons, was found to be of very little relevance from an economic perspective. For the purpose of this study, an economic definition based on the distribution of net (residual) profit and competition in the respective sector was used to determine if a firm was to be regarded as private or state-controlled. The distribution of net profit gave a reasonable reflection of the ownership composition and its change during a firm's life history. Private-state "joint" ventures with mixed shareholding were included in the study as long as one individual state agency did not control more than thirty percent of capital and the management did not have to “report” to a superior state agency or was under obligation to transfer all profit to a superior administration.

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

Data Analysis

As the main goal of the study was to gain insights into the functioning of Chinese business relations, the analysis rests on cases from the life history of firms as well as simple qualitative statistics derived from the questionnaires. The open interviews followed the procedure known as Event-History-Designs (Carroll and Hannan 2000). The questions focused on development over time, more precisely, on the sequence of events. The events referred to qualitative distinctions as defined in the conceptual set-up. Such events were the establishment of a company, including activities that preceded the registration of the firms or the start of production, changes in ownership structure, mergers, diversification and expansion beyond the local nexus. It is worth mentioning that our contribution is mainly exploratory and not meant to test existing theory. Instead, its primary purpose is to contribute new insights to the under-researched field of domestic corporate-level developments and hopefully stimulate further research into private entrepreneurship in China.

The configuration of firms

Graph. 1

For the companies interviewed, the reforms started when in the early eighties national and provincial policies defined two sectors in which bureaucratic control over output, prices and profit was relaxed: the market sector in rural areas and urban consumer markets (stage 1). At the same time, reforms did not define ownership. Villages were acknowledged as natural owners of all communal physical and financial assets within their boundaries. They in turn respected private households as another natural owners so that quickly lease contracts were re-established. The 'growing out of the plan' (Naughton 1996) meant that the establishment of the market sector was not achieved by a transfer of assets from state to private ownership, but by transferring control rights to private economic actors or the lowest administrative level (townships and villages). Private entrepreneurs or villages could start producing goods which were no longer restricted by plan production quota. As long as the same range of goods was also produced by state firms, competition between village and private business on the one side and units subordinate to state planning on the other was the consequence. With increasingly more goods released from state control, the state-owned sector responded to the new market opportunities by expanding into those areas as well. As state-owned enterprises (SOEs) were restricted in realising profits or other economic benefits, they started transferring profitable assets from state into collective ownership. This entrepreneurial initiative benefited their enterprises; it enabled SOE managers to retain part of residual profit within the firms and use it for capital accumulation, investment or monetary incentives for managers and in labour contracts. Outwardly, this change appeared as downsizing, as production lines were leased out or used to form new semi-independent enterprises.

What we observe then in this stage is how the new market sector attracted entrepreneurial activity that sprang from three sources. One was private entrepreneurs (often family based), one was villages and townships turning entrepreneurial by initiating or expanding the activities of their small local workshop and production units, and the third consisted of state-owned enterprises entering the market through informally establishing firms with expanded rights to control internal resources and residual profit.

Stage 2 was characterised by inter-firm and firm-government contacts and led to a multitude of organisational forms of firms. Private/public collaboration in the form of long-term joint ventures increased over time. This contract-based collaboration was not limited to the pooling of resources by two or more firms, but included alliances with local governments that offered property rights protection, information, or favourable taxation in return for a profit share. Firms based on natural ownership started to disappear. In the case of township and village enterprises (TVEs) this meant that they were either converted into private companies via management buyouts, merged with other local companies, in some cases they expanded and transformed themselves into holdings. The interviews suggest that network structures surrounding the firm as well as *tacit* acknowledgment by the respective stakeholders were the decisive factors for the emerging organisational forms. If , for example, the organisational structure was able to secure steady input, vertical integration became feasible. If stakeholders could broker investment in unrelated lines of production, diversification was an option. If the stakeholders agreed to stay out of the operational side of the firm, it could opt for a professional management structure. As a consequence, the new firms were overall characterised by a weak organisational identity. Their product line could change as quickly as their form or their “ownership” and size.

After the recession 1989-91, which exposed many firms to their vulnerability, a period of contraction and streamlining started (stage 3), which is still ongoing. Irrespective of state or private “ownership” and control, firms started to look more and more alike. The general trend as seen from the interviews is as follows. First, stakeholders turned into shareholders with registered capital for which they could expect dividends. Second, corporations started to dominate the new business sector. The incorporation of firms is accompanied by the registration of capital for each shareholder. Third, since the promulgation of the Company Law, firms as legal persons have become the owners of all the firm’s assets including land usage rights and physical assets.

All in all, after a period of experimentation, some organisational forms of firms were discarded. The surviving firms acquired a stronger organisational identity with respect to their property rights, governance structure, and interaction with their political and social environment. On the other hand, with respect to size, range of operation, product choice, name and legitimation, Chinese firms still only show a weak organisational identity.

Interacting economic agents

Graph. 2

The model so far concentrated on the economic actors in the new business sector. In a next step the driving forces that can explain the expansion and contraction of different forms of firms through the three stages will be explained. The reforms started with some bold political decisions by the central government (stage 1).

(1) *The transfer of initial property rights to villages in return for the latter's' acceptance of hard budget constraints*. With the financial reforms in 1985 local governments were expected to increasingly finance local expenses by local revenues (Ma 1997). The greater autonomy to levy local taxes (disguised as "fees") introduced fiscal federalism. Local governments trying to secure a safe revenue base (tax plus share of profit from village firms) faced competition from other local jurisdictions.

(2) *The transfer of rights to control assets and the right to accumulate capital within the limits of the market sector as defined by the central government.* The liberalisation of production planning plus excess demand for most consumer goods created a sellers' market in which almost anything would sell. In the shortage economy that characterised China in the eighties, even "outdated" and low value added forms of production promised high returns. Unsurprisingly, private firms started in those sectors where little capital investment was necessary, so that individual savings or the pooling of savings or rents were enough to start a business.

(3) *Transfer of the right to control production plus retention of a profit share for state-owned enterprises after they had fulfilled that production quota targets.* The transfer of these rights resulted in a decentralisation as state firms had discretion to expand into new business activities.

As a consequence collective or state firms tried to enter the new profitable market sector. Stage 2 therefore saw rapidly increasing competition between all three officially acknowledged forms of firms, the TVEs, state sector firms and the new private firms. While competition in the product market with its spectacular price cuts, product innovations and insolvencies captured public imagination, it was the less visible intense competition in the factor market that explains the organisational change and economic development in the new business sector in stages 2 and 3. In comparison to product markets, transferability of input and resources in the factor markets were severely hampered by the state control over assets such as land, hard to transfer input such as information and knowledge, and state guaranteed "local" monopolies over assets and/or licenses. Under these constraints firms had basically three avenues to gain access to input and assets. First, they could bribe, i.e. offer money in return for control over assets; they could, second, cooperate with those firms whose capital stocks included the needed assets; or, third, they could form alliances with those who controlled access to needed assets by offering them a "stake" in the firm or even merge with them. As the interviews and other studies show, firms used all three strategies, leading to a variety of ownership structures and organisational forms. In other words, the pressure through increased competition and institutional insecurity in stage 2 (as well as the recession in the late eighties and early nineties) caused firms to create linkages and explore new forms of cooperation and led to collaboration between firms and agencies that were holding assets or able to promise protection. State agencies in turn had an interest to collaborate with individuals controlling scarce managerial skills or good ideas. The fora, not to say the 'marketplace', for these complex interactions were networks whose membership cut across the different institutional boundaries. Membership in these networks carried with it the possibility of acquiring informal stakes in enterprises that wanted to benefit from the functional services that the networks could offer.

Stage 3 is characterised by a gradual institutionalisation of these links in a large-scale process of corporatisation of firms which resulted in the legalisation and acknowledgement of property rights and increasing routinisation of the use of contracts.

The corporatisation process directly involved the previously formed networks to the degree that networks among the stakeholders were accepted as new "natural owners". Both the amount of capital registered (whether or not with the help of a preceding audit) as well as the composition of shareholders could depend on the outcome of bargaining within the networks.

Determinants of organisational forms

The life histories of firms as recalled in the open interviews reveal that in almost all cases the development (or expansion) of firms is accompanied by organisational change (Krug 2002, Krug and Hendrischke 2002; Krug and Mehta 2002; Krug and Polos 2002). The case studies offer illustrative evidence for the assumption that these changes reflect a *systematic response* by firms and entrepreneurs to changes in the environment, namely to the high share of non-tradable input and resources, lack of contractual security and relational risk, ill-functioning markets for information, and weak property rights.

The poor resource base is a major concern for all firms in their initial stages. As the interviews show it is less the infrastructure or input in general than managerial skill and access to non-tradable input that are seen as crucial factors hampering entrepreneurship. As argued elsewhere, the need to broaden the resource base makes *social capital* the most crucial single factor in the firm's initial endowment (Krug and Polos 2002).

First, in order to secure access to input and resources controlled by state agencies, firms need to form *alliances* with local authorities. Such alliances are not restricted to the provision of infrastructure and assets under public management, such as industrial sites, water, roads, and skilled labour. They can secure licences, for export for example, protection against confiscation and extortion by old state monopolies and SOEs, or "insider" information about business opportunities and changes in tax legislation and regulation. In return, local authorities, such as village governments or other regulatory bodies, become stakeholders or even recognised informal shareholders of an enterprise with entitlements to a share of residual profit or regular payments. In particular in stage 1 and 2 these shares tend to remain vague for political reasons and are often enough disguised as "fees" or as intra-firm consumption, when, for example, local authorities transfer entertainment and other expenses to the firms' budgets, gain access to cars and other services, or negotiate "consultancy" contracts.

Second, social capital is instrumental in creating links, such as mergers, joint ventures, and acquisitions with other firms that happen to possess needed valuable resources for which they themselves may have no or less profitable use, such as land usage rights, export or other licences, or control over production sites in other locations. The sometimes bewildering acquisition and merger policy in which for example a computer company buys a cement factory, or a Bosch car electronic dealer moves into catering business, finds its explanation in this need to acquire non-tradable input rather than in a commercial strategy to consolidate or diversify lines of production. As the interviews further show, even with operational profits close to nil or negative firms can expect a favourable deal as long as their capital stock is attractive enough for a business partner. As in the case of alliances, new firms will emerge in which the shares of the two (or more) partners remain vague.

Third, state agencies, firms and increasing numbers of academics and self-employed entrepreneurs with expertise in the new service sector (marketing, banking, IT) form networks in which hard to trade knowledge and information can be “swapped”. The know-how involved is not limited to scientific knowledge which due to the socialist past remains highly concentrated in the formal education and science system despite the many commercial firms that have been established by academic institutions in order to sell their expertise. In stage 3 knowledge increasingly includes “trade knowledge” or “business know-how”, i.e. information about prices, business practices, or income- and price-elasticities of demand etc. As a result, beginning in stage 2 networks became more *unspecified* in the sense that aside from technical competence they start to store information on market situations and opportunities. On this basis, they are able to assist in brokering deals between firms in need of knowledge or other resources and those who own idle resources and assets. Starting in stage 3 networks can act as natural owners of know-how to the effect that they initiate new firms and decide on an appropriate ownership structures. In this stage, new firms are more likely to be started by network-based arrangements than by individual entrepreneurs who may only be able to rely on the help of local authorities or by state agencies with or without the help of individual managers.

Fourth, the predominant feature in this stage is the incorporation of firms, i.e. the move to convert unspecified ownership rights into registered capital and dividend income. This move is more than a technical device by which incorporating firms establish private property rights, as it ensures that networks become an embedded feature of the future business system.

All in all, while at the beginning organisational change reflects the need to broaden the resource base of firms, the last years show that individual and “institutional” investors try to establish private property rights. Whereas traditional networks such as the family, the village, or people from the same county were called upon to provide support for business start-ups in an environment of low transaction costs, they are quickly rejected the moment other network formations offer better economic results. The new networks that replace them offer better conditions in terms of larger pool of assets, more diversified pools of people with different skills, less costly access to non-tradable input, and more efficient ways to secure contract enforcement and property rights protection.

Seen from this perspective it is no longer a surprise that during the interviews new entrepreneurs dismissed the family as an institution for building up competitive firms. The family is rather seen as one form of network that might provide a good starting point but quickly exhausts its unique transaction cost advantage that rested on trust and low enforcement costs.

Coordination of business relations

Tab. 1 gives an overview of what is "on the menu", i.e. the set of possible institutions from which hypothetically Chinese firms and entrepreneurs could select.

Tab. 1 **Building Business Relations**

Forms	Institutions	Characteristics	Enforcement	actors
External Institutions	1. property rights	• constitution	State agencies	central state
	2. market discipline	• Spot market	End of contract,	competitors
		• Keeping aloof	Revolving contracts	Business partners
	3.law	• Written contracts • Specification of procedure in case of conflict • Specification of procedure in case of coerced mergers or hold ups	Court ordering	Courts, lawyers
Interactive Institutions	1. Collusion of self interest	• Joint ownership resource (knowledge, information) • Mutual dependency • Sharing rules of co-operation rent	Cross share-holding, Sunk costs, Collaterals, reputation	Business partners, networks
	2. Trust	• Routines • Reciprocity, obligation • Personal bonds, reputation	Exclusion, ostracisation	Family, village, social groups, networks
	3. Networks	• Size and scope • Specificity, scaffolding • Internal governance structure	Entry / Exit	Social groups, groups with joint interests
	4. Arbitration	• Third party neutrality • High/low cost decision	Private ordering	Business community networks

The use of the term ‘weak institutions’ for China’s business environment implies that external economic institutions guaranteed by a “constitution” and enforced by political agencies are ill functioning, if not non-existing. In order to develop a private business sector firms and entrepreneurs therefore have to search for and agree upon alternative institutions. It is assumed that in the case of privately organised co-ordination mechanisms the costs for a monitoring agency and the costs for alimenting a sanctioning fund need to be carried by all those who have subscribed to that institution (Yamagishi and Takahashi 1994). For this reason alone each member has an incentive to carefully screen the entry of new members.

While the first institution in Tab. 1 (collusion of self-interest) is a quasi-market institution, and the fourth (arbitration) is a quasi-legal institution, the second and third group are institutions that are closely linked to culture.

As the results from the empirical study show, Chinese business partners do indeed employ predominantly social solutions while the use of external (legal or economic) institutions is still limited (Tab. 2)

Tab. 2: Ways of dispute settlement

Variables	Frequency	Percent
Solutions for irreconcilable disputes		
(1) Recourse to the law court	4	10.5
(2) Social solutions	22	58.0
Private ordering	9	23.7
Help from a local community representative	1	2.6
External arbitrator	12	31.6
(3) Economic solution: abandon the relationship	12	31.6

When asked in the questionnaire about the reasons for adhering to agreements or, more generally, for general success in business relations, the answers also point into the direction of social coordination and social sanctioning mechanisms. The results underline the extent to which the family as an institution for building up a business has become obsolete.

Tab. 3: Importance of economic and social factors for business relations

Variables	Mean	Standard Deviation	n
Reasons for abiding by agreements			
Threat of legal redress	4.9	2.0	36
Firm's reputation	6.1	1.1	36
Personal reputation	6,1	0.9	36
Honour	5.7	1.5	36
Friendship	4.5	1.2	36
Family connection	2.5	1.5	36
Need for future business	5.6	1.2	36
Requirements for the success of a business relation			
Mutual co-operation	6.2	0.7	36
Mutual trust	6.3	0.7	36
Prompt delivery and payment	6.1	1.2	36
Family connections	2.5	1.7	36
Personal contact	4.6	1.5	36

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

As argued elsewhere (Krug and Belschak 2002) and detailed below, these findings support the literature on Chinese business norms with respect to patterns in social choice.

(1) Chinese entrepreneurs will strive for collectivist problem resolution leading to the building of networks as loose social institutions enabling contact, co-operation in

actions (Yeung and Tung 1996), sanctions for transgression in behaviour (Greif 1993). In this case all the psychological, cultural, and economic literature, argue that for co-ordinating their network activities

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

(3) Taking Chinese high performance-orientation into account, these approaches further assume that Chinese entrepreneurs have internalised economic reasoning to the point that

(4) Networks will not be maintained irrespective of functional value. Indeed, in the literature on Overseas Chinese communities and business groups, it has been argued that their networking is a business activity in which cultural norms and economic reasoning are seen as mutually enforcing (Lever-Tracy 1996, Menkhoff 1992, Redding 1996, Tsang 1998, Whitley 1990, Yeung 1994, Xin and Pearce 1996).

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

there are signs that litigation is gradually becoming established as a cost-saving device for solving routine disputes.

Summary: Toward a new business system

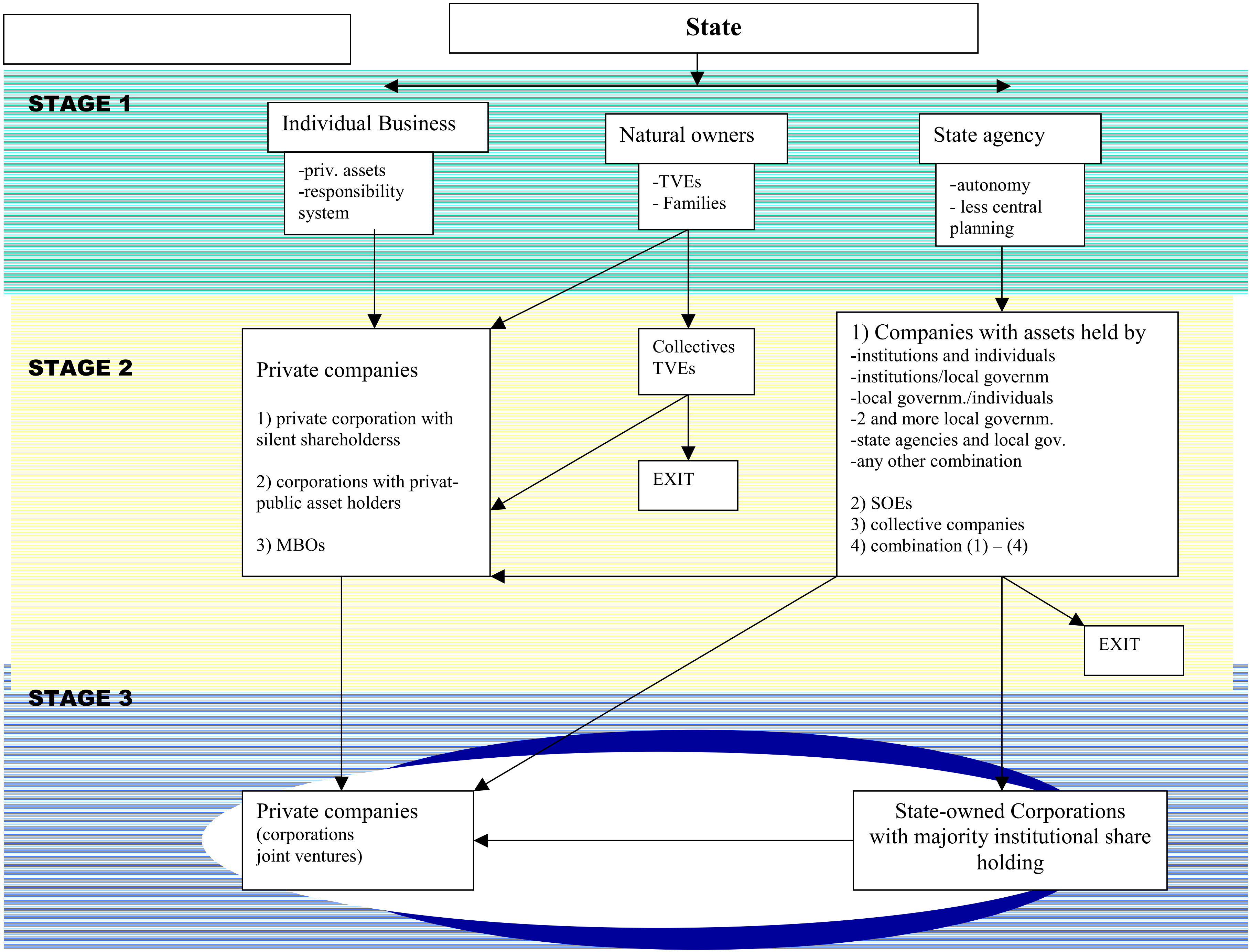
As evolutionary economics would claim, the emerging business system in China has indeed experienced experimentation and selection. Experimentation is driven by innovation, in particular organisational and institutional innovation, and learning by individuals and firms. The selection process, on the other hand, is driven by the performance-orientation embedded in Chinese culture, as well as by competition and cooperation when collective practices and joint investment promise higher returns.

Tentatively the following picture of the near-term future business sector can be offered: First, the business sector will be dominated by incorporated firms in which state agencies as institutional investors (and capital owners) will remain major share (and stake-) holders. Incorporation and privatisation have not spelt the end of bureaucratic involvement in the business sector. Second, it is safe to assume that entrepreneurs and firms in the same but also across different sectors are connected by a variety of networks, which in addition to the conventional tasks described in the literature serve three additional purposes. These networks accumulate and store “options” on future business opportunities; they function as platforms for learning; and they define and enforce business practices. Third, the development of competitive markets and more effective legislation will drive out some services networks perform today, when, for example, liberalization in the markets for assets, risk or information will lead to an increase in tradable input. It seems however likely that networks that are already getting entrenched in the economy as owners or resources and major providers of transaction cost advantages will take on new functions and not disappear in the foreseeable future.

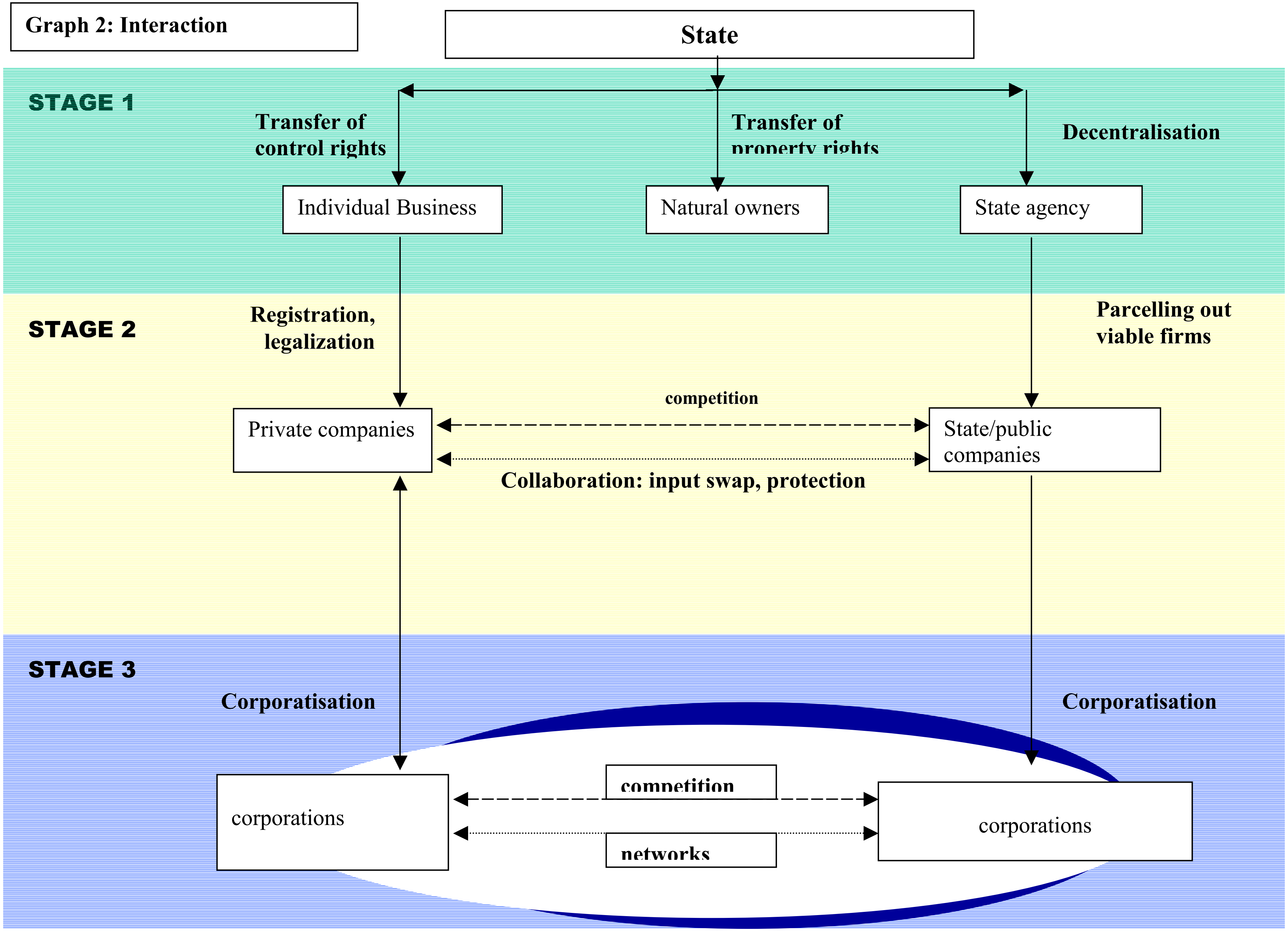
In comparison to other (Overseas) Chinese business systems, networks in the People's Republic of China will remain rather *unspecified* with respect to formal structure, membership and tasks. They will be less linked to one sector of the economy, and will more closely monitor individual behaviour instead of the behaviour of firms. Pending further research it can also be assumed that we might find two forms of networks in the future which differ with respect to size and diversification in network production.

One kind of network, not described above, will connect the "old" big firms in the former/present state sector (Nolan 2001). This type of network will concentrate on political lobbying for maintaining a high threshold for *exit*. State and party cadres, therefore, will dominate membership and will use political forms of competition and collaboration to keep the old industries and firms going.

The second kind of network, described above, will connect smaller and younger firms while offering a broader range of "services". In particular, such networks will broker technical and managerial knowledge, and make sure that both the threshold for entry and exit remain low.


State
STAGE 1
Individual Business
-priv. assets
-responsibility system
Natural owners
-TVEs
- Families
State agency
-autonomy
- less central planning
STAGE 2
Private companies
1) private corporation with silent shareholderss
2) corporations with privat-public asset holders
3) MBOs
Collectives TVEs
EXIT
1) Companies with assets held by
-institutions and individuals
-institutions/local governm
-local governm./individuals
-2 and more local governm.
-state agencies and local gov.
-any other combination
2) SOEs
3) collective companies
4) combination (1) – (4)
EXIT
STAGE 3
Private companies
(corporations
joint ventures)
State-owned Corporations with majority institutional share holding

Graph 2: Interaction



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