The Emergence of a Private Business Sector in China: The Case of Zhejiang

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Abstract	This paper is part of a broader research project that aims to analyse the emerging private business sector in China by focusing on three topics.	
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The Emergence of a Private Business Sector in China: The Case of Zhejiang

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Research agenda

What follows is part of a broader research project that aims to analyse the emerging private business sector in China by focusing on three topics.

1. In a descriptive analysis it will be asked what types of firms have emerged since macroeconomic changes and legal and constitutional reforms in the mid and late 1990s have created the economic and legal basis for the existence of private enterprises. What property rights regime has developed, what governance structures and organisational forms are employed, and what routines or custom underlie exchange relations with suppliers, customers and banks?[1]

2. On the theoretical side new approaches from industrial ecology, including evolutionary economics, will be drawn upon (Hannan. M.T. and Freeman, J. 1989; Nelson, R.R. 1996. The Sources of Economic Growth) to discuss the *survivability* of the different forms of firms that we observe. Such an agenda requires as a first step an understanding of how diverse the private business sector in China actually is and what produces this diversity. For example, different forms of firms may reflect different property rights regimes or different business environments to which economic actors respond in a systematic way. Alternatively, cultural differences within China may make firms respond to the same environment in different ways.

3. Secondly, from a dynamic point of view, there is a need to analyse how firms develop over time. Change can be expected to result from two effects: On the one hand the ongoing reform process, in particular changing legislation and further liberalisation of private exchange, are opening up new sectors for private firms while forcing state-owned firms (SOEs) to "privatise" assets. On the other hand, the dynamics in existing markets for goods and services, including a gradually liberalising capital market, plus the rapid integration into the world market that will further accelerate with China's entry into the WTO, open opportunities for those firms which are able to respond by changing their initial property right regime and organisational structure[2].

4. Both steps are connected. From an evolutionary perspective organisation theory assumes that the selection process in competition will drive out some forms of firms. Identifying those of transitory nature will help to find those likely to survive. As the theory shows survivability depends crucially on the *liability of newness* (Stinchcombe, A. L. 1965), i.e., a situation where firms need to function in an environment of high uncertainty, and on *inertia*, i.e., the fact that the evolutionary process sets a premium to keeping organisational structures stable. The last point seems counterintuitive as it is generally assumed that firms need to constantly change in a dynamic world. And indeed, production, techniques and size might be different and must change over time. Yet, crucial for the survival of a firm as an organisation is the establishment of structures that guarantee *accountability, predictability* and *reproducible structures* (Krug and Polos 2000).

In the absence of unitary legislation that could offer contractual security for private firms and burdened with the co-existence of a market and a socialist sector, firms had to find surrogates that allowed predicting the behaviour as well as enforcing promises and obligations of other firms (Putterman, L. 1995; Whitley, R., Henderson, J., Czaban, L. and Lengyel, G. 1996). The theory suggests the formation of routines and custom as they are developed by frequently interacting economic agents (the so-called industrial districts). These frequently interacting economic actors form networks which in turn will monitor and enforce (tacitly) agreed upon routines and by doing so establish a specific business environment. The research project therefore assumed that

Assumption 1: As the development of firms in China is strongly linked to location, jurisdiction (better: local politics) and low factor mobility, different kind of business environments (for the concept, see Whitley, R. 1995) *will emerge, subsequently leading to different forms of firms.*

The empirical evidence suggests that local political differentiation in regards to business policies is more strongly reflected in actual measures and regulatory policies than in official political statements. Local politics can affect the business environment in terms of jurisdiction and legal infrastructure as well as factor mobility.

Assumption 2: To the extent that networks contribute to the establishment of accountable, predictable and reproducible structures and behaviour they provide the *necessary stability that allows new firms to experiment with product lines, techniques and different organisational structures.*

One empirical finding of the research, not further elaborated on here, is that the Chinese firms developed routines and custom by reviving old institutions, such as cropsharing and contracting, and by hijacking social institutions, such as the village and the family, for economic purposes (Krug and Polos 2000; Krug 2000). In so far that old institutions and social organisations differed widely in the past across China, different proto-forms were revived and modified. This part of research asks for a comparative analysis on a province-by-province base that has just started.

Research methods:

The fieldwork was undertaken in the years 1993, 1996, 1997 and 1999.in the northern province of Shanxi. For the first time in 1999 a standardized questionnaires developed in Rotterdam was used[3]. This questionnaire was taken to Zhejiang in October 2000. What follows below is based on the Zhejiang data set. The questionnaire includes two sets of questions (out of altogether 257 questions) that focus on the organisational form of the respondent firm and the firm's history. The first set asked about ownership, control, and bankruptcy, access to bank loans and the configuration of business relations around the firm. The second set, a mixture of standardised and open questions, asked the respondents to recall how the firm was established, how the parent company – if there was one – was established, or what the history of the "grandparent" company was. This procedure allowed to circumvent the restrictive official classification system of firms as found in the statistical yearbooks. Instead, the selection of firms was based on the assumption that the necessary requirements for a firm to operate outside the state administrative system are that

- an individual or a group of individuals has to take the risk, and
- can therefore claim part of residual profit,
- while being able to manage as well as allocate or transfer the firm's assets[4].

For access to entrepreneurs we depended on university support, local Party officials and personal contacts. It cannot be claimed that the sample of respondents (31 interviews) is representative by the usual social-scientific standards of Western research practice since all of those contacts may have applied their own filters to the sample. The alternative would have been to wait for the time it takes for Western sampling methods to be acceptable and practicable. Nonetheless, we suggest the resulting data set is rich in information and offers a unique glimpse of key features of entrepreneurship in Zhejiang Province at this stage of the reform programme. This in turn might bring into focus general characteristics of a reform process in China which Zhejiang seems to be leading in a number of areas.[5] The data set on Shanxi serves as a kind of benchmark as the sample size does not allow the use of quantitative methods. Types of firms and trends were assessed as suggesting a general trend or supporting one of our assumptions if the Shanxi data set did support our assumptions.

For the same reason, instead of offering statistics, several biographical sketches of firms will be recorded as cases. This format allows a better and livelier description of the variety of strategic moves by the different players, which ultimately led to the establishment of firms in the present form. While the general findings will be summarised presently, the case studies are kept in the Appendix.

Findings

The fieldwork in both provinces strongly suggests a modification of conventional concepts with respect to the *Modern Theory of the Firm*, as promulgated by Williamson (for example, Williamson, O. 1993), conventional P*roperty Right Theory* (for example, Furubotn, E. and Pejovich, S. 1974), and the concept of Networks (for example, Powel, W.W. 1990), or China-specific explanations (Boisot, M. and Child, J. 1999; Redding, S.G. 1996.)

Entrepreneurs and Firms

Usually concepts start with a firm that is described by a production function, an initial endowment, and/or the legal registration as a firm by which by which contractual security, property right protection and liability is ensured. As will be seen in what follows the entrepreneurial activities which precede the founding of a firm can be all but decisive for both the initial endowment, the property right structure and the environment in which a firm functions. Entrepreneurial activities also pre-determine to which extent a firm makes use of markets or personal connections or what kind of networks are invested in. The first result is that Chinese firms are based on *entrepreneurship by alliance* (Krug and Mehta 2001)[6] for the following reasons. Start-up firms depend crucially on the pooling of resources controlled by different person or state agencies. Therefore, to get access to land, capital, machinery, or skilled labour, an entrepreneur needs to persuade or coerce others to co-operate[7]. As long as input factors cannot be traded, other returns need to be offered to those who are in control or actual possession of valuable resources. Social capital, here seen as the ability to persuade or coerce others to give up control over resources in return for monetary or other rewards becomes then the most crucial single component in the initial endowment of a firm. It can be argued that social capital defined in such a way is a necessary prerequisite for private property rights.

Types of Firms

Depending on the relative weight of each component, different forms of firms can be distinguished.

1. Private entrepreneurs are basically Schumpeterian entrepreneurs, i.e. have an idea and social capital, but are in dire need to find partners who control access to capital, machinery, land or potential customers (Case 2)[8].

2. In contrast, SOEs start with machinery, land, and buildings and a workforce but need innovative managers, and increasingly more connections to private domestic and foreign firms. With ongoing reforms, in particular the implementation of the Company Law since 1994, their ability to coerce economic agents into co-operation diminishes. To assume that a firm owned by a state agency must be managed in a bureaucratic style is short sighted and does not take into account successful examples of state entrepreneurialism (Duckett 1998). While state entrepreneurialism generally confines itself to the business area of the original state administrative unit, SOEs can also act like private firms when they have to offer monetary returns for co-operative behaviour, compete for managerial professionalism try to maximise profit by expansion into new business areas or new partnerships (Case 3 and case 6). The equation private ownership equals competitive profit making firms, while public ownership equals protectionism and “losses” does not hold when SOEs can hire professional managers who require full operational control and can demand market conditions and special incentives (see also Spechler 1995). Such firms are legally SOEs whose shares are exclusively in the hands of state agencies, but operationally display characteristics of private enterprises.

3. The most intriguing type of firms are private/public corporations where one or several private investors and some state agencies establish a new firm, usually with private share-owners in control of the management (Goodman 2000). In this case too the private shareowners are the Schumpeterian entrepreneurs who bring in new product ideas, new technology, and access to new networks (Case 4).

When talking about the emergence of private firms in China, a word about the role of the family is appropriate. One of the most spectacular result of the fieldwork was that after twenty years of reform family enterprises in which family members take active managerial roles in order to protect family interests seems to be becoming obsolete in Zhejiang. This trend is confirmed by data collected in Shanxi. In both cases it was asked to which extent the family was used for pooling resources necessary for establishing the firm, such as savings, entitlement and labour,. In both cases the family only came in via short-term loans that had to be paid back meticulously. One interpretation of this puzzling result was that a poor entrepreneurial candidate most probably would also have poor relatives, , or else one would have to stretch the notion of family to such a size that even the most generous definition of extended family, clans or lineage would be stretched[9]. While it was originally expected that the family would enter the family business when and if the firm expanded so that one owner alone could no longer control and supervise internal and external transactions, the empirical research among entrepreneurs in Zhejiang found strong reservations against family firms beyond the scale of small restaurants or groceries (Case 1). Entrepreneurs who had known family firms which had ceased to exist explained that the original owners/managers were not willing to take in relatives who claimed managerial positions when they lacked the necessary competence. Instead they preferred to split the firm amongst all relatives who had contributed their savings for the establishment of the firm. In one recorded case such a split let to intense competition between six firms, which originally were set up by one individual and his five sisters. Thus, unlike the traditional family firm which provided workplaces for family and where subsequently relatives were to be found in all kinds of manual and managerial jobs, these firms insist on competence rather than blood relations when recruiting employees. Moreover, rather than trying to build up a “family holding” which would significantly enlarge the resource base, splitting the assets at an early stage is seen as a necessary way to keep the family – as a social unit – intact. To put it polemically, the family is served to the detriment of the expansion path of a family firm[10]. Nevertheless, there are family firms, however restricted to labour intensive, small-scale endeavours where often enough the whole firm consists of a father, the mother responsible for accounting and children and other relatives providing the necessary work force. Another reason mentioned for the involvement of family members is the stipulation in the Company Law that requires a minimum of more than two shareholders for a Limited Liability Corporation. In other words, if a private entrepreneurs wanted to become incorporated, s/he had to find reliable co-shareholders by making spouses, siblings or other family members’ sleeping partners with a small share in the enterprise.

The growth path of firms

The interviews showed that the growth path of firms depends on two different factors: one is changing legislation and administration, the other is the need to change the capital structure and organisational form which no longer matches the business environment. The fieldwork shows that three features dominate the growth path of firms.

1. State or community owned assets converting to private corporate usage. This development started in the countryside (case 5), but as case 3 indicates was imitated by other state agencies[11]. TVEs and village governments were capitalising on their control over land to make windfall profits in the early and mid 1990s. They used these funds to set up and expand enterprises under their jurisdiction, or later secure shares in existing enterprises (Weitzman and Xu 1994). Incorporation under the Company Law provided the legal security for this type of expansion.[12] While accompanying local (for the most part provincial) jurisdiction is reducing the ability of former collectives to hold majority shares, they still have a secure minority share. In Zhejiang, this growth path has become increasingly restricted, as local governments have counteracted real estate speculation through public bidding requirements and the establishment of competing industrial zones which have to compete to attract investors.

2. Social capital driven expansion of firms. One of the problems that still burdens the Chinese business sector is the non-tradability of crucial input. One direct consequence is that a core business cannot easily (at low costs) be built up. Each input that happens to be under the control of one entrepreneur or one network needs to be exploited. This explains partly the chance element in Chinese entrepreneurship, more precisely why firms instead of aiming at vertical integration or investing matching lines of production invest in what seemingly is a completely different sector. If however, a network will not let entitlement, knowledge and social capital lay idle, a business outlet needs to be found that matches best the stock and composition of the

accumulated input (case 6). In the more mature environment of Zhejiang with its stronger legal protection for private enterprise, vertical integration can be observed when entrepreneurs are able to target partners who have access to specific networks or can utilise social capital.

3. Management buy-outs. One of the most interesting developments of the new business sector are the means by which formerly state controlled assets get “privatised”. After all, new firms seldom start from scrap. In particular, firms in the traditional manufacturing sector need buildings, technical equipment and machinery and for which there was no domestic market in the eighties and that they could not import for lack of capital,. In hindsight the firms’ histories reveal a certain procedure in this type of privatisation. At the beginning some individual is “chosen” to run an enterprise which at that time is still “owned” by a village, a ministry or any other state agency. This manager is given control over the firm’s assets to the point that s/he is entitled to change production, composition of the workforce, distribution channels, and product prices. In return, the manager is also entitled to part of (net-) profit [13]. The higher his share on net profit the higher the risk an individual manager takes, but also the more he earns if the firm under his control is prospering. It is this mechanism which created the new “middle class” in China, which to a great part consists of managers of still state-owned firms[14]. In some cases in Zhejiang, this empowerment of the manager was phased in and one of the incentives were share options. Over the years manager could accumulate enough capital to buy the whole firm or part of the shares. To offer

> such kind of incentive contracts is quite common in Zhejiang after the new Company Law came into force in 1994.

This share ownership by management should not be confused with the granting of employee shares. In most cases employee shares need to be seen as a bonus, if not a kind of forced saving, by which the company can strengthen its capital position and reduce labour costs. So long as the employee shares cannot be traded and do not entitle the owners to more than a symbolic role on the Supervisory Board of the company, one cannot speak about “shares” (case 7). In several cases did the company decide not to pay any dividend, a policy that is easier to implement when the share-owners are employees with a more long term commitment to the survival of the firm compared to share-owners who are “outsiders”. As before it is the combination of (technical) innovativeness and social capital that is rewarded with a premium in today’s business environment: managers who found a viable line of production and can secure permanent input in form of connections and co-operations are rewarded with ownership over economic assets.

Summary: On the transitory nature of Chinese firms

Which type of firm will become the dominant organisational form in the future will depend again on the interplay of political change and the inter- and intra-network behaviour that will emerge with increasing liberalisation. Without further comparative studies on different locations, the scenario looks as follows:

1. It is not hard to see that SOEs as “private” companies are likely to have a short life span. Their survival depends on first favourable legislation, which is unlikely under the present political regime, which aims at relieving the state’s responsibility for enterprise activities. Their survival depends also on the on-going co-existence of a state and a market sector. The moment they cannot longer appropriate control over resources or government , they will loose their major comparative advantage. Functioning at the edge of what is legally accepted also implies that they will find it hard to design an organisational structure and forms of business relations which guarantee the necessary factors for survivability, namely accountability, predictability, and reproducible structures.

2. Private firms can and will survive depending on two developments. One is further liberalisation and improvement of the legal system. Another is the frequency by which private firms will interact with each other. The latter is essential for the development of routines and custom. Both developments have the effect that the level of uncertainty can be reduced which in turn means lower risk for new firms and entrepreneurs. Subsequently more, relatively risk-averse entrepreneurs can be mobilised, so that in the end a “virtuous” cycle can be unleashed – the kind of development we observed in the past. It is tempting to argue that it does not matter whether these private firms take the form of family firms that we know from overseas

Chinese or whether private entrepreneurs will go on looking for alliances with state agencies. Their economic stability will depend on how quickly all input can be traded, and how quickly competitive capital markets will emerge.

3. Similar arguments can be found for the survivability of private/public firms. The better they function and the longer they exist, the less reason to change the property rights structure or organisational form. Seeing the advantage of the network-linked organisational structure of the firm as it developed at the end of the eighties and the nineties, the next generations might shy away from further organisational changes which, after all, would imply at loss in predictability, and accountability, at least in the short run. After all, networks and market economies are compatible, as none the least the literature shows.

APPENDIX

Case 1: The Family Firm

Ownership: The Garden of Manifold Pleasures is one of the new Limited Liability Corporations whose directors and shareholders feel slightly overwhelmed by their new titles and authority. In 1984, when the respondent (004) and his wife were assigned a building and surrounding space of some thousand square metres 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 capital. However, their family's cooking skill 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. Their interest had been to create employment for the family and in turn have the family create employment for other people in the area. They fulfilled these expectations by increasing their staff from the original eight family members to 52 employees in 2000. The neighbourhood committee received a nominal rent from the restaurant

When local policies required that the street committee enterprises be converted into Limited Liability Corporations, the respondent had to ask his two sisters to become shareholders in order to comply with the required minimum number of shareholders. Together the sisters received a share of 30 per cent on the understanding that they would be sleeping partners without any business involvement, while he and his wife took a 60 per cent share. He 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 as an investment in social capital, in view of their original contribution of land and premises and in order to keep the good relations going. The street committee itself had not request a share, as it had absolved itself from any responsibility by ensuring that up to the conversion, the respondent had not incurred any debt and that itself had not incurred any liability. Profit is distributed according to the shares.

Governance structure: All major decisions are made by the respondent and his wife. His managers have the right to decide about the hiring and firing of non-essential personnel and the purchase of daily supplies in their areas of responsibility. In his line of business, he is operating in a spot market, he has no fixed supplier relationship, as he buys his supplies from local markets. The law affects him in form of the Company Law which dictates the structure of his company. Apart from that, the company is a family enterprise.

Expansion path: The respondent 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 and invest in his business. He can do this from the savings he is able to make. The only occasion when an investment required bank finance was when he bought a new set of Karaoke equipment. However, this was a relatively small sum and he only borrowed the money from the bank only because he did not want to draw funds from his fixed-term deposit. He does not think that he could ever face bankruptcy, the restaurant is too small and as it has not debt, his risk is minimal. At worst, he and his family could face unemployment. Practical issues that concern him are pollution problems, he has to keep an eye on this as legal enforcement of environmental regulations is quite strict.

Case 2: The owner/manager firm

Ownership: This small hotel (respondent 011) near one of Hangzhou's universities was set up in 1993 under the 'Wenzhou model'. That is, it is legally a private partnership, registered under the name of the General Manager. During the economic boom in 1993, hotel rooms were scarce and the General Manager and four friends who regarded this as a safe investment. The General Manager had the technical expertise, two other partners were in trading businesses and the third local partner had useful contacts from his previous job looking after the visitors of a provincial government institution They provided the initial capital and now hold between twenty and thirty on percent of the shares each, except for a partner from Taiwan who holds ten per cent. The General Manager holds 23 per cent. They receive dividends according to their share. The initial capital was needed to buy a thirty years land lease contract from the Municipal government and for construction of the hotel. As a private partnership they were not required to convert into a Limited Liability Company under the Company Law.

Governance structure: What makes this company typical is the configuration of business relations around the hotel. As is best known from traditional Chinese family firms, business relations are based on trust rather than on contracts or market allocation. Thus, the company knows no statutes; there is only a written but informal contract between the five partners, which gives the General Manager full autonomy to run the hotel. The degree of personal trust required for this arrangement is surprising, given that one of the owners lives in Taiwan and is hardly in a position to monitor operations of the hotel management. In other words, four of the owners need to be regarded as "sleeping partners" who will not interfere in the management, at least as long as the firm produces satisfying results.

Likewise, customer relations are also built on trust. As a small private hotel, the management finds it hard to make it into the tourist guides and brochures of the state dominated or even private travel agencies. The main business therefore relies on the good relations with a large number of different institutions, including the university in whose vicinity the hotel is located. For example, good personal relations with the economic faculty of the university ensure that their visitors will be accommodated in the hotel and that it will host their dinners and banquets. Business from this one personal contact adds up to annual revenues of around 100,000 RMB. The General Manager estimates that he is cultivating around one hundred such personal relationships.

Expansion path: Originally, the enterprise was not able to borrow money from banks. This changed with the commercialisation of the banking sector in 1995. The hotel is now evaluated as a good risk on the basis of its assets of approximately 50 million RMB. With this asset basis and its good track record, the hotel has a credit line of 20 million RMB with the bank, at a present exposure of 6 million RMB. However, the General Manager considers that the fixed interest rates of the banks are not attractive enough to expand his credit with them.

Subsequently, despite intense competition in the market, the likelihood that the firm could go bankrupt is seen as low and limited to the – unlikely – case of a reconcilable conflict between the five owners. The owners have agreed to sell the hotel once the General Manager has reached retirement age in about ten years time. Thus, neither the ownership structure nor the organisational form of the firm is meant to last.

Remark: This case does not help to solve the question to which extent notions of trust or reciprocity will shape the behaviour of the private sector in Zhejiang, let alone China, in the future. The trust-based form of organisation is seen as effective in the short-term business adventure, but as respondents made clear, functions in a small size firm only.

Case 3: The SOE as a private company

Ownership: A government Bureau, of provincial ministerial rank, of Zhejiang (respondent 007) owned a large piece of land on Yan'an Road, the main shopping artery of Hangzhou. In 1995, it decided to invest in a first-class hotel in one of the city's best locations. The Limited Liability Company set up for this purpose involved five state-owned corporations under the Bureau: the Commercial Group (Jituan) as the main commercial arm of the Bureau with a share of 95 per cent and four smaller companies involved in real estate, different products and transport. The investment of the five share-holder of the new company, adding up to 160 Mio RMB, consisted essentially of the land originally owned by the Bureau and an adjoining site which was purchased by the Bureau for the purpose of building the hotel. The hotel was opened in 1999. 190 million RMB were provided by the local Construction Bank. Unlike private investors, the state-owned corporations had no problems in securing a loan of this magnitude. The management does not have to worry about the high debt ratio since, as was said, it can rely on the shareholders to help out in times of financial difficulties. .

Governance structure: In formal terms, the hotel is run by a team of seven managers. In practice, there are two groups of managers, three managers are representatives of and delegated by the Grain Bureau, they include the deputy general manager, who is responsible for the commercial performance of the hotel, and the financial controller. The other team consists of professionals with experience in the trade. At the head of the latter group is the General Manager, an experienced hotel manager from Hong Kong with previous work experience in China. She is expected to work as an interim manager in the following areas. She is to train the internal staff and to use her connection with travel agencies in Hong Kong to get the hotel into the travel guides outside China. She expects to have trained a successor in about five years time. The organisational frame of the hotel reflects this division and shows a remarkable degree of professionalisation with a functional departmental structure. The operation of the hotel is too recent to expose any of the potential conflicts that might evolve between a strictly commercial orientation and social interests of the shareholders, such as hospitality for their contacts. The fact that the General Manager was not given financial responsibility indicates an awareness of the risks on part of the shareholders.

Expansion path: The hiring of an internationally experienced professional for internal organisation and marketing reflects the awareness of the shareholders that their privileged position as state-owned corporations does not secure commercial success for the hotel. The hotel has to compete with Sino-foreign joint venture hotels in the vicinity and also with up-market hotels in Shanghai. This competitive pressure is clearly felt. While the expansion of the hotel business is not impeded by lack of access to finance or government connections, the state-owned shareholders have identified professional management and international levels of performance as their primary goals to secure a stable position in the market. The management is determined to make profit, get access to the Hong Kong travel agencies in order to secure long-term contracts for package tour tourists, and further build up an efficient organisational structure.

Case 4: Public/private corporations

Ownership: In the late eighties a local wool factory (respondent 027) came under pressure to stay competitive in a sector that at an early stage had become “liberalised”. The initial response was to upgrade facilities and to invest in new machinery. Quickly it became obvious that the quality of the locally available raw material was too low for the new equipment and their products did not succeed in the international market. As a result, the company faced a loss of close to 2 million RMB in 1988. During the following five years, two new directors tried to turn around the enterprise, but ended up in 1993 with 5 million RMB worth of unsold goods and cash reserves of only 42,000 RMB.

At this stage, the deputy director of another state-owned enterprise in the same industry was brought in and given authority to pursue his own commercial strategy. His commercial analysis was that the market was oversupplied at the lower end and that a turn-around required moving up-market and building supply chains with foreign companies. The enterprise also had to shed 105 workers of its workforce of 235 people. By importing raw material from France, the United Kingdom and Japan, and operating sophisticated textile machinery under licence from Italy, the new director turned the factory around. It became profitable again, achieving its first profit in 1994, and by 2000 was well positioned in the international market. These changes in commercial strategy were accompanied by a diversification of ownership. In the newly established Limited Liability Corporation, the local city government, as the original owner of the enterprise, retained a share of only 22 per cent. New external institutional investors are holding 35 per cent. They include four domestic customer firms with a total of 33 per cent and a United Kingdom supplier firm with 2 per cent. The management received a minority share of 42 per cent, of which 20 per cent were allocated to the three deputy managers, while the remaining 22 per cent are owned by the new director who thus became the largest single share owner with the same share as the local state-owned holding company. While his shares have a nominal value of 11.25 million RMB, he was only required to pay 2.5 million RMB.
This ownership structure is transitional. In 1999, the provincial party/state organisation of Zhejiang initiated a new move towards privatisation, giving majority shares to entrepreneurs such as this respondent. At the time of the interview, the local Party Committee had already made the decision and was waiting for approval from the Provincial Party Committee and Trade and Economics Commission.

Governance structure: The change in ownership was accompanied by a change in the rules on decision making. While decisions that affect the total assets of the firms, such as expansion, establishing subsidiaries or planning joint ventures, are de jure and de facto subject to the approval of the shareholders, the operational side of the business is fully left to the top management. They decide about strategy, risks and further development of the company without interference from the local state administration.

Expansion path: The manager does acknowledge the crucial role of state agencies in the past, in particular for getting investment funds and export/import licences. Yet the firm insists that it has outgrown this kind of business environment. Further development will depend on a deepening of the international division of labour, in practical terms, on a further integration of the firm into the value chain of its customers. The company is presently the first of its kind in China that is able to operate in the sophisticated end of the market. China’s accession to the WTO is expected to work to the benefit of the firm.

Case 5: From TVE to capital income earning community

Ownership: What today is a Welding Materials Company (respondent 014) started as a conventional TVE in 1995 on the outskirts of Hangzhou. As usual all assets were assumed to be the property of the whole village, so that in fact no property rights were ascribed. Two years later when the village had to acknowledge that without some drastic changes the TVE would not survive, the following agreement was reached in the village. The villagers would once more mobilise their private savings as well as public funds. In this way two million RMB were raised. Seven individual villagers contributed another five million. The money was used for buying a 70 years land lease contract from another village further away that offered favourable land prices. Subsequently the new company by its registration distinguished between two groups of capital owners. One is the village, which is registered with forty nine per cent of the capital in return for the raised capital and the machinery from the old TVE. The other group consists of the seven individual investors, who hold fifty one per cent. The capital owners decided to appoint a professional manager. They found a university graduate from Zhejiang University who managed to turn the TVE into a competitive firm.

Governance structure: What is remarkable with this ownership structure is that aside from the professional manager only five out of the seven individual capital owners are members of the board of directors. In other words, the village keeps completely out of the daily management. Also noticeable is the fact that most of the workforce was recruited from outside. The contrast with a TVE of the old type could not be more striking and confirms a national trend observed in better-off regions of China. Moreover, while originally TVEs were established to provide the village leadership with a stable revenue base by attracting new workplace generating firms, in cases such as this a village invested in a firm outside its village boundaries and accepted to employ a workforce from outside. The village profits only in form of dividends paid. In short, the company was seen as a way to pool private savings, which were invested in a venture that might promise higher returns than other forms of investment.

Expansion path: The management does no longer see the TVE, or other remnants of the socialist past, as a constraint to future business development.

Case 6: Social capital driven expansion

Ownership: Although economic reforms had little ideological impact on the Chinese university system which remains under strict Party control, universities as well as academics are allowed if not encouraged to better exploit the knowledge accumulated in China's academic institutions. One way to do so is to establish commercial firms in which academics are shareholders, advisers, or form part of the regular staff. Thus, for example, in the nineties Zhejiang University started a commercial company for selling its knowledge (respondent 015). This company in turn established a dot.com company in which the university through a commercial holding company keeps a thirty per cent share, while an local Trust and Investment Corporation from a smaller provincial city owns another thirty percent. Forty per cent however represent individual shares. The new company's purpose is to establish, design and maintain e-commerce websites and provide related services for commercial firms.

Governance structure: The company employs a large number of academics (300), each of which is employed for a specific project such as the design of a website for a firm. Usually those who established the business contact or acquired new orders will implement the project. Subsequently, the remuneration system knows three components, a rather low monthly wage, a commission for new orders or new customers, plus options for the company's shares. At present two hundred, i.e. two third of the employees own shares. As long as these shares cannot be traded and do not give voting rights to their holders, they have to be regarded as a special bonus and a work incentive for the employees. One representative represents the employees in the ten-person management team. The management on the other hand does not know any fixed salary. Instead they get 1-2% of total turnover of the firm. In short, the company uses highly powered incentive contracts which directly links individual salary to work effort, competence and individual social capital (such as personal connections) as the following show.

Expansion path: Thanks to the language advantage and academic connections the company could quickly get access to international suppliers such as IBM and other US firms from which they lease hardware. The single most crucial factor however was that the academics had good connections with China Telecom which created a starting opportunity for their company. It was this contract with the state-owned Telecom Company which allowed the dot.com company to gain its initial reputation. The personal relations within the academic community, the high educational level and the connection with China Telecom allowed to keep the initial (capital) investment costs low. Moreover, with the backing of its shareholders, the company was able to choose amongst several banks when loans were needed. This is a position not many new entrepreneurs find themselves in. While human resource management relies on the informal university network of personal connections, the company on the other hand works within an environment of "hardened" legal contracts. Thus, for example the lease contracts with IBM are the same as standard Western contracts. A notary certifies all domestic contracts. This last point refers to an attempt to increase contact enforceability within the Chinese legal system. In a first step courts will inquire whether the disputed contract fulfils the requirement of a legal binding contract – a procedure that easily can take twelve month – this step can be dropped if the initial contract was certified so that court proceedings can start immediately.

Case 7: Management buy-out

Ownership: One example of such a management buy out is a copper tube factory (respondent 022), where the present owner/manager worked in the collective firm that was founded in 1985 as a TVE and which he operated under a contract responsibility system. . In 1989 when the company's business volume halved as a result of the restrictive economic policies of the central government, he could use some private savings and could borrow 160,000 RMB from friends at the enormous interest rate of 24 per cent per annum to acquire a big majority share in the company. While this start-up capital was quickly paid back by him, it was enough to give him control of 89 per cent of the new company, which continued with the assets of the old collective firm. In 1990 the firm could report a net profit of one million RMB, that was large enough to attract the attention of banks which under Zhejiang's more liberal administrative regime were allowed, if not encouraged, to give loans to private rather than collective investors. With such a loan of 530,000 RMB the owner/manager built a new factory in another village. He was forced to still register as a collective company, but in return he did not have to pay the high tax rates a private company would have had to pay at that time. In 1993, another change in the ownership and governance structure was established. Replacing the ill-defined "collective" as a minority owner, 70 till 80 individual persons for an investment of between 2000 and 3000 RMB each bought the remaining 11 per cent of company shares from the collective. Together they re-registered now as a limited company. Finally, in 1998 the owner/manager bought 8.7 per cent of these 11 per cent owned by other private investors. In short, within fifteen years he turned form a manager of a not too well functioning collective firm into the only owner, controlling all but 3.4% of a firm that registers as a Limited Liability Company. He insists that the 3.4 per cent belong to his employees who by forming a "social organisation" (shetuan) act as an institutional owner of the firm, more precisely the shares they control.

Governance and expansion path: Unsurprisingly, he alone formulated the firm's policy and expansion path for which he claims the market – and not SOEs or state agencies – are decisive.

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[1] Useful additional information can be found in the literature that focuses on the role of the (local) state (Unger and Chan 1995, Oi 1995, Unger and Chan 1999) and property rights (Putterman 1995, Oi and Walder 1999) in China. An economic analysis can be found in Weitzman and Xu 1994; Ho 1995; Parker 1995; Spechler 1995.

[2] For an overview see Qian 2000.

[3] In the beginning, 1993-1997, the research relied heavily on the assistance and logistical support provided by Prof. David S.G. Goodman, University of Technology, Sydney whose help is gratefully acknowledged. The design of a standardized questionnaire could not have been accomplished without the collaboration of Dr. Judith Mehta, University of East Anglia, Norwich. The generous financial support by the Royal Dutch Academy of Science, and the Trustfonds of the Erasmus University Rotterdam was essential in executing the pilot studies and the field work.

[4] In economic legal terms such a definition accepts a *possessory right* instead of a property right as a workable criteria for private ownership. the rationale behind this is that anybody who can exclude others from the use of one resource needs to be regarded as an owner. For a general discussion see Posner 1980, and Krug 1979a.

[5] For a general overview of Zhejiang's economic development, see Forster 1998, and Forster and Yao 1999.

[6] See also individual chapters in Oi and Walder 1999.

[7] For a general overview see Rozelle, S. and Li, G. 1998; Krug, B. 1997b; Nee, V. 2000; Unger and Chan 1999.

[8] For a general discussion of entrepreneurship see Kirzner, I.M. 1973; 1985.

[9] As Sinologists have claimed for quite some time, the notion of the extended family is predominantly found in the south of China (Eastman 1988, Freedman 1970, Fried 1953). Yet, this would not explain the lack of family firms in Shanxi only. In Zhejiang however that is so close to Wenzhou where it is claimed that strong family firms have dominated economic development in the past, the same picture can be found. Family firms are limited to small-scale traditional service industry. Nolan and Dong 1990; Liu 1992.

[10] Such a calculus is not necessarily new in Chinese behavior. In the past too, family holdings were split if and when conflicts became to tense. See Krug and Frey 1987.

[11] Zhejiang played a prominent role in this process by promoting the 'Wenzhou model' from the 1980, see Nolan 1990, Liu 1992,and Whiting 1999.

[12] Localities can vary considerably in the enforcement of the Company Law for their jurisdiction, for Shanghai see Guthrie 1999, for Beijing see So 2000.

[13] This is a traditional sharecropping contract, which has been known in China for centuries. See Cheung 1969a, 1969b, Krug 1997a: Cheng, L. and Rosett, A. 1991.

[14] Goodman 1998a.

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