Institution Building and Change in China

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Institution building and Change in China

As China's economy continues to grow and to diversify, many aspects of its transformation remain unexplored. Explaining economic performance simply as the result of policy changes that introduced market reforms does not stand up to scrutiny. More empirical work is needed. By identifying the formal institutions that contributed to economic transformation and growth (World Bank 1994, OECD 2005) empirical studies offer a useful first step; yet, they cannot explain the underlying processes that led those institutions to emerge. What will be attempted here is a dynamic perspective focusing on institution building and institutional change (North 2005). Such an analysis can also contribute to the general understanding of economic transformation. After all, despite differences in size, culture and geography, China and the European transition economies share the socialist legacy and the problems connected with the dismantling of a planned economy. Ultimately, the analysis breaks new ground for the literature on comparative business systems. The question whether China (or other transition economies) will end up with a new variety of a capitalist system, and thereby change the structure of the world economy, cannot be answered without a better understanding of the processes that initiate and direct institutional change. The conceptual challenge is to identify systematic features that allow distinguishing different institutional settings "over time", i.e. the *dynamic perspective*, and different local business systems within China, the *comparative perspective*.

Institutional change and governance structures

In the present paper one such feature is singled out, namely *governance structures.* Governance structures are at the heart of institutional change in form of enforcement agencies

and enforcement (transaction) costs (North 2005), and as authority relations are one of the most crucial features for distinguishing different forms of capitalisms (Whitley 1999).

In the most general terms governance structures refer to institutions, formal and informal, and co-ordinating mechanisms within firms and within the economy (EBRD 1998, p.27). Whether at the political level in form of a constitution or at the individual level in form of legally binding contracts, formal or informal, governance structures shape an emerging business system for the following reasons: First, a governance structure defines defaults for individual behaviour and by doing so limits the range of response to any individual decision. This can be viewed as the *uncertainty reducing effect* (Krug and Polos 2004). Second, governance structures define what is compatible with the envisaged form of a market economy, the *normative effect* (Voigt and Engerer 2001). Finally, governance structures are a necessary requirement for effective governance when they define the kind and scale of enforcement agencies, such as a state agency or a firm, i.e. the *authority relation effect* (Whitley 1999).

Likewise positive incentives shape the emerging business system when they first, offer rewards to encourage certain courses of market conforming actions. The best known example are private property rights which unleash entrepreneurship. This can be viewed as the *mobilisation effect* (Lipton and Sachs 1990). Second, positive incentives create new – individual or collective - economic actors such as firms or entrepreneurs. For example offering a premium for risk taking creates entrepreneurs; rewards for professional skill create administrators, while a combination of both create managers, all of which will replace political cadres. This can be viewed as the *elite exchange effect* (Nee and Peng 1994). Third, positive incentives influence the speed of transformation by inducing economic actors to use market conforming courses of action, accept (market) competition, or invest in human capital whose value increases with expanding markets, the *resource recombination effect* (Stark 1996, Grabher and Stark 1997).

In the light of these findings China's economic transformation in a comparative and dynamic perspective raises the question, "which form of governance for which individual or collective action was introduced and by whom?" Yet, such a question overlooks the fact that economic transformation is a problem of institution building rather than of institutional change. In institutional change the analysis assumes that the expected returns from an alternative institution can be calculated (Nee and Stark 1989). In contrast, institution building in transition economies needs to acknowledge two considerations. At the aggregate level it is evident that the state or political leadership plays a major role during the reform process. At the individual level institution building refers to a situation where expected returns from institutions are hard to assess. The fact that both the comparative business system and the Public Choice literature take a capitalist-democratic environment as a given, something that might or might not be the outcome of institutional change in China, does not mean that they cannot contribute to the analysis. The Public Choice (or Political Economy) literature endogenizes the political market in an elaborate analysis of the spatial dimension of institutions, for example in the discussion about optimum government size, the fiscal equivalence principle or fiscal federalism (overview in Mueller 1989; see also Alesina 2003, Blanchard and Shleifer 2000, Qian *et al.* 1999, Montinola *et al.* 1995, Qian and Weingast 1997). The comparative business system literature on the other hand includes non-codified rules, such as norms, and social co-ordination mechanisms, such as families, associations or networks, which explain change or location-specific differences beyond the range of codified laws and national legislation (Whitley 1999, Hollingworth *et al.* 1994). In other words, the analysis of transition economies, in particular of China, does not require a new theory, but rather a re-combination of analytical tools developed and tested for other economies and business systems.

From this perspective, an explanation of China's economic transformation starts with the questions " which actors establish and/or enforce governance structures and incentives? Are

the governance structures codified or un-codified, do they rely on state or other enforcement agencies or are they based on social (local or nation-wide) norms? What is the interaction between different "suppliers" of governance? What is the spatial dimension of different forms of governance and how doe the different forms interact?"

Institutional change and diversity

While governance structure is a crucial conceptual tool, the empirical challenge is to explain *diversity in the development of (local) business systems* (Keng 2001, Bao *et al.* 2002, Xu 2002*).* Different regions in China developed differently with respect to both economic growth and transformation. The causes and effects of a "local state" and local business systems as part of institutional change and as a salient feature of a future national business system need to be integrated into the analysis of China's transformation. To focus on governance structures seems a promising analytical procedure that allows identifying different business systems irrespective of their link to a nation state. To organise the different aspects of economic transformation, and to highlight the characteristics of institution building, the following will separate analytically two forms of institution building. The first is the step from the initial commitment to reform at the national level and the institutional choice that defines governance structures enforced by national and central government agencies: national legislation, Communist Party resolutions or national enforcement agencies[1]. This part will outline the effects of the 1978 reforms with respect to the emerging diversity and choice of governance structures. In order to see to which extent politics contributed to institution building three aspects will be singled out: the emergence of the local state as a major actor in choosing governance structures, the range of choice within the frame of "market reform", and the factors that influence the choice of governance structures.

In contrast, the second step concentrates on institution building and firm organisation within the general frame as defined at the national government (and Party) level. The behavioural assumption it that organisational and institutional choice reflects the general political-economic environment. Entrepreneurs, networks and local autonomy are identified as the major drivers of further institutional change in response to uncertainty, transaction costs, and costs for further institutional change. The paper concludes with some remarks on the costs of institutional change and transformation.

Diversity as the outcome of institutional choice

The emergence of the local state. In contrast to European transition economies, China's reforms started with a *weak commitment* to a market economy. Unlike the European cases where the commitment started with the prescribed privatization of state controlled assets and firms, the commitment in China to a "market economy" was converted into a policy of *devolution of power*, without a clearly prescribed path of privatization. In a first step villages were allocated the (collective) property rights over land and physical assets in the early eighties. In combination with the right to establish institutions at the local level, such as acknowledging private firms, levy taxes, and privatise former state assets, the system led to a far ranging form of "federalism" (Qian and Weingast 1997). Rather unique and not usually found in fiscal federalism is a system of tax farming where government agencies at all levels can "farm out" regulatory power and policy implementation in return for negotiated revenues [2]. The farming out policy is based on contracts between different layers of government, and often enough complements or competes with state activities implemented by specialised bureaucracies. Though officially tax farming has been abolished in 1994, it still exists *de facto*. It is therefore the *co-existence of two forms of (state) governance*, namely bureaucratic procedures, and contracts and bargaining by which policy at different levels of

governments gets co-ordinated. It is worth stressing that the reforms do not allocate tasks to different levels of government. Instead it is left to the provinces how much direct control will be executed over the sub-provincial government agencies, as there are districts, counties, and townships. Policy outcomes therefore can reflect negotiation within one locality, between localities at the same level, or between different layers of government. Likewise, the constraint on different courses of action is not defined by legislation or bureaucratic procedures; the constraint is rather defined by permission from superior units.

For analysing economic transformation this co-existence of bureaucratic and negotiation mechanisms means that the conventional models of bureaucratic decision making assuming hierarchy and compliance are of limited explanatory value only. This is so because they cannot contribute to the analysis of tax farming, and the farming out of regulatory power. Likewise models of federalism are of limited value only as they rely on a constitutional separation of power (and tasks) within the political and bureaucratic system (Montinola *et al.* 1995, Qian and Weingast 1997). Not enough is known about the "rules of the game" of the farming out procedure, and maybe most crucially, not enough data are available that would allow linking specific levels of government to specific "preferences" for policies or procedures. For this reason the paper talks about the "local state" when referring to all government units *below* the provincial level, and in cases when functions and behavioural assumptions cannot be empirically linked to different layers of government.

On one side an argument can be made that the central government favors a rational, Weberian bureaucracy (Krug *et al.* 2004; Wong 1992; World Bank 2002; Brean 1998, Nee 2000), as the establishment of a national (as opposed to local) tax authority shows[3]. On the other side the central government uses the downward transfer of collective property rights and regulatory rights as a positive incentive for local cadres to accept the reform programme, to compensate them for the loss in direct resource control and the hard budget constraint that imposed on them by the central ministry of finance (Brean 1998).

In short, devolution empowered local government agencies to design or experiment with their own set of governance structures while the transfer of property rights to the village level offered revenue sources which made (the "rich") local government agencies rather independent from budgetary transfers. Yet, they are not completely independent. Aside from the permission of superior administrative and political agencies the overall commitment to the reform program is still ensured by the *nomenclatura* system of the Communist Party. The prerogative to promote, re-deploy, or dismiss (usually on the ground of corrupt practices) local politicians or bureaucrats ensures that the Communist Party sets the defaults for reform-conforming individual behaviour. Nevertheless one of the most striking results of economic transformation in China is the emergence of *different local business systems* where local units at the sub-provincial level emerged as jurisdictions characterised by different regulatory regimes.

How does the China-specific literature account for the devolution process? A short overview over the literature reveals competing explanations with respect to causes and effects. On the one hand there is the Fiscal Federalism-argument which argues that the diversity of local business systems leads to jurisdictional competition which in turn is a strong surrogate to ill-functioning market competition (Qian and Weingast 1997). On the other hand there are approaches which claim that the fragmentation is the outcome of "weak" institutions, in particular a weak central authority (Krug and Polos 2004, Huang 2003, Gong and Feng 1994; Che and Quan 1998; Montinola *et al.* 1995) which invite "local solutions" in institution building. Undisputed in both streams of literature is that sub-provincial government agencies together with the new entrepreneurs firms became the main agents for institutional change in China. While the China-specific literature emphasizes the positive affect of such co-operation whether in the form of networking (Hendrischke 2006), local autonomy or corporatism (Oi 1991, 1992, 1995; Walder 1995; Unger and Chan 1995) on overall economic performance, the Grabbing Hand-hypothesis developed for the European cases of transition economies

insists on the negative effects due to rent-seeking and corruption (Shleifer and Vishny 1993; 1998; Frye and Shleifer 1997; for China see Young 2000). The lack of consensus indicates the conceptual problem: The positive effect of fiscal federalism points to jurisdictional competition as a factor effectively constraining the "Grabbing Hand" (Zhu and Krug 2006) of the state. The positive effect of local corporatism in contrast is linked to private-public alliances, which effectively limit competition and by doing so contribute to local growth.

The local state and choosing governance. Leaving aside the question of the effect of such an institutional frame on overall economic performance the question that needs to be addressed is first how to measure institutional diversity in China and second how to identify factors that explain the emergence of institutional diversity within China. In this case the findings from the comparative business systems and the transformation literature help to single out four different types of governance structures by which local business systems can be distinguished.

State involvement in transformation and economic development. The local state can remain aloof limiting itself to a set of tasks as defined by central legislation, the provision of local public goods and act as neutral arbitror in economic conflicts. On the other hand, the local state can see itself as a dominant planning institution and regulator of economic development. For doing so the local state will make full use of the regulatory power tolerated by the superior state agencies or the national legislation. In particular the local state will establish agencies that directly control resources and protect industries, i.e. the case of the local Industrial Development Zones, or offer monetary incentives for politically agreed upon economic activities, such as investment in R&D or education.

Organizational choice and corporate governance. The local state can tolerate all forms of co-operation and organizations around manufacturing and other business purposes as long as competition within the local boundaries and beyond is not threatened. Alternatively, the local state can purposefully establish or maintain local monopolies and cartels via keeping SOEs or

by defining entry barriers for newcomers often including specific requirements for the organizational form, such as joint ventures. Whether co-operation that is based on codification or registration, informally acknowledged or regarded as illegal draws the attention to networks and networking which will be discussed later. Here it suffices to say that because most networks start as locally embedded organisational form it is the local state whose tolerance if not support is essential for their functionality.

Property rights regimes. In contrast to the central state, the local state can guarantee property rights *de facto* by not contesting private property rights or by guaranteeing contractual security for individual business deals. For this reason the local state can also define which sector, which activities and which resources will remain under state control or shifted to private ownership. By doing so the local state defines its' reach over the economy, or, in other words, the scope and scale for the emerging business sector. Directly linked to the problem of property rights is the *governance of performance and selection*. Local state intervention defines whether market forces determine success or failure, or whether technocratic entry and exit criteria supplement market forces to protect local industry.

Governance around innovation. University education is outside the control of the local state, leaving “generic” innovation a concern of central state agencies. Yet, the local state has considerable leeway when it comes to the dissemination of technical knowledge - whether incorporated in universities, foreign firms, or the human capital of young entrepreneurs. Licensing private vocational training schools, or investment in primary schools help to change the human capital base of the locality; licensing start-up firms which often enough serve as “incubators” for SOEs as in the case of the IT sector (Greeven 2006) changes the knowledge base of local industry; facilitating the establishment of supply chains around foreign firms helps to attract further FDI, and integration into the international value-chains. In short the local state can define a policy which is market driven, i.e. following the demands from entrepreneurs and foreign firms, or can insist on its own planning capacity of innovation.

Linked to the governance around innovation is the *governance around standardization of technical routines and business practices.* The local state tolerates the establishment of (technical) routines, or business practices, via market forces when it is acknowledged that investment flows into routines that promise highest returns, thus allowing the best practices getting imitated across sectors. On the other hand, the local state can also opt for a model where standardization follows decisions within a state bureaucracy, or think tank.

In other words, the local state can opt for specific forms of governance in all of these four areas, the combination of which will then lead to a regulatory regime by which different localities within China can be distinguished. In a democratic environment one would talk about a “constitution”, as this institutional architecture delineates the public and the private sector, and defines what is permissible, i.e. regarded as *market conforming* behaviour or market conforming organisation (Buchanan and Tullock 1962).

At first sight it is intriguing to cluster the different regulatory regimes in China around the well-known “types” of a (Anglo-Saxon) liberal, or Arm’s Length State, as opposed to an interventionist or Developmental State. Such an attempt suffers from two misconceptions. One is that any attempt making the regulatory regimes in China “fitting” the existing categories precludes an analysis open for the possibility that a new variety of a capitalist system may emerge within the Chinese context. Moreover, as will be seen presently, the state is no longer the sole supplier of institutions. New economic actors establish governance structures within the defaults set by the reform programme and defined by the local regulatory regime. A business system is however the aggregate of political and private institution building. Before the problem of private institution building is taken up, the question which factors will influence local governments when they opt for specific governance structures needs to be addressed.

Factors influencing the selection of local regulatory regimes.

The local state's decisions, which institutional architecture to establish and enforce can be assumed to be non-random. In order to explain the institutional choice in China, the structural factors influencing choice need to fulfil two requirements. First they need to be able to explain the diversity across local jurisdictions and second, they need to explain the decision which kind of a regulatory regime is chosen. The variables singled out in what follows rely on the economic growth theory, the analysis of transition economies, New Institutional Economics and the political science literature in particular where empirical studies are available that can substantiate the claim.

The economic condition. That the economic conditions in a country of the size of China differ is inevitable. The literature on institutional choice as for example the OECD (2005) but also the general economic literature suggests a range of factors, such as market size (Romer 1986; Lucas 1986) [4], labour market for "professionals" (Nee and Peng 1994; Xu 2000. See also Yarrow 1999; Bian 1997; Benjamin and Brandt 2002), state ownership (Smyth and Binder 2004; Guthrie 1999; Nee 2000), income level (Bao et.al. 2002; Brean 1998; Krug *et al.* 2004), and attractiveness for (foreign) capital inflow (Qian *et al*. 1999; Braunstein and Epstein 2002).

It is not hard to see that the smaller market size, the more dominant the centrally controlled state sectors, the more relying on budget transfers and/or the less attractive for FDI, the smaller the range of activities the local state can formulate, implement and finance. So far the economic factors hint at the *leeway* the local state enjoys for establishing a distinctive institutional architecture. What kind of an economic regime will be chosen depends on further factors which deserve a closer look.

The historical legacy. Some of the features, such as the inherited ownership structure or the dependence on transfer income mentioned above could also have been classified as part of

the historical legacy. Here two additional factors are singled out that are more connected with the mechanisms how decisions at the central level affected different locations differently.

First, the geographical distribution of the inherited *capital stock*. Investment decisions in the past followed political, military-strategic decisions rather than economic considerations (Bickford 1994). For this reason the capital stock and physical infrastructure in China were more geographically dispersed, when compared for example with Russia. It would however be misleading to assume that past state investment (in form of SOEs) automatically generates a comparative advantage. Only those SOEs and infrastructure outside the control of the military command add to the capital assets over which local jurisdictions can claim control. "By default", the local state turned entrepreneurial. Lack of managerial expertise outside the pool of (Party) cadres and lack of private financial means for investment in the capital stock forced them to operate firms. It is only over time and depending on the interaction with potential private entrepreneurs that local jurisdictions can actually choose a regulatory regime. It is therefore not surprising that the new role of the local state did neither follow a *big-bang* immediate withdrawal (such as auction off assets) nor any incremental withdrawal designed by think tanks. Instead positive incentives were experimented with which would ensure the collaboration of private resource (human capital) owners. Second, the *positioning of local jurisdictions within the national political hierarchy*. It is less the general opposition to the reform course but the relative positioning of local leaders that proves to be essential in choosing governance structures. In the One-Party system of China, local politicians have to accommodate two "constituencies": the upper-level (Party) hierarchies and, increasingly more, local demand. Formal and informal connections help to gain access to information, transfer income, and approval to experiments. Thus, for example, shortage of capital (for necessary investment) can be overcome either by lobbying for central subsidisation or by mobilising local resources, in return for handing out (economic) privileges or sharing authority with certain social groups (Goodman 1995; Nee 2000; Lan 2001).

In short, the legacy of the past left an unequal distribution of assets and power positions. The result is a clear division between localities that face a soft budget constraint, while at the other extreme there are local jurisdictions almost completely depending on (national) transfers. As empirical studies have shown income from land management can easily add up to fifty per cent and more of total revenue (Zhu and Krug 2006). The more physical and political assets controlled by a local jurisdiction the softer the budget constraint and the more leeway it has to choose that economic regimes it sees best suited.

Institutional innovativeness. That the innovative capability is not independent of political institutions (Hayek 1973; also Kornai *et.al.* 2003; Kirzner 1985) and human capital accumulation is straightforward. Thus, in transition economies the available competence poses a hard constraint on economic transformation. Institutions need to be established which *re-align the interests of political and economic actors* (Nee and Cao 2004) by offering incentives for investing in market-conforming human and social capital. The need to overcome the managerial constraint relies – at least in the short run – on the collaboration of all social groups in control of physical assets and human (and social capital). The tax farming system proved to be an effective institution, as did the Chinese version of a management buy-out by which mangers could convert their expertise into ownership in firms.

Coordinated via contracts with the superior agencies or informally via networks such a sharing system ensures that the lessee, i.e. the local governments can capture the gains "at the margin" and thus directly profit from local economic development. Regardless whether employed in taxation, land management, privatisation of industrial assets, or setting up local regulatory regimes this farming out policy ensures that the transformation gain is divided between the central and the local level (see the different contributions in Brean 1998. For a comparative view see Shleifer and Vishny 1994; 1993; Litwack 2002), and explains the increasing geographical diversity that can be observed.

Capabilities of the bureaucracy. One legacy of the past is that there is no independent pool of bureaucrats and managers from which the Chinese transition economy could recruit new administrators at the beginning of the reforms. Aside from the inherited *nomenclatura* the only other group where competence in economic/administrative affairs can be expected are the (successful) managers and entrepreneurs in the same locality. As these have a similar interest in the overall development of the local jurisdictions, a co-operation strategy, or strategic alliance is a solution for solving the human resource management problem (see below]. Localities differ widely in their access to both competent administrators in the bureaucracy and access to competent managers of local industries.

To sum up, devolution enabled local government agencies to choose different governance structures. Such kind of institutional choice is non-random but influenced by economic and political factors, as well as by the socialist legacy and scarcity of administrative and entrepreneurial expertise. Yet, the chosen institutional architecture is not identical with the emerging business system. Once a locality has chosen a regulatory regime, the new and old actors will choose for means how to organise production, how to form agreements and enforce them, and to which extend revive or capture other social mechanisms or organisations, which they expect to facilitate private exchange.

From corporate governance to the emergence of a local business system

One has to keep in mind that the political and bureaucratic system is no longer the only supplier of governance structures. As was shown earlier the local state emerged as a powerful new actor on the supply side of institution building; others are entrepreneurs and firms. The local business systems within China emerge out of the interaction between *new economic and political actors who search for institutions that help to better cope with uncertainty, and*

*transaction costs in an environment that offers low costs for institution building (*Qian 2000; Nee and Cao 2004; World Bank 1994).

Initially, in the new private business sector private firms are the recipient of institutional change rather than actors pressing for change. This is so because a governance structure within and around firms needs to be established first, which empowers them to act as "autonomous" economic agents. The search for such *corporate governance* becomes a question of political and economic entrepreneurship, while the outcome is then a specific local business system. This search is not an academic exercise but depends on the frequent interaction between (potential) business partners, and between the economic entrepreneurs and local government agencies. Two institutions, namely the formal institution of local autonomy, and the 'informal' institution of networking shape the interaction. Though certainly not mutually exclusive, the functioning and instrumental value of networking and local autonomy at best will be analysed separately. Once more, it can be assumed that the selection of a corporate governance structure is non-random. Instead three factors, more precisely: economic problems, can be identified which influence the selection of corporate governance: Uncertainty, transaction costs and the costs for institution building.

The following summarises how economic actors in China respond to uncertainty, transaction cost, in how far this contributed to the emergence of new institutions and how the emergence of new forms let to new institutions. The summary follows the findings of an empirical research project, which has so far interviewed 140 company managers, 40 tax officials within the tax bureaucracy or in the finance departments of the local state, i.e. township and county level in three provinces (Shanxi, Jiangsu and Zhejiang) since 1999.

Corporate Governance as a means to reduce uncertainty. In transition economies uncertainty refers to technical and market uncertainty plus *procedural uncertainty.* The latter of which reflects weak or ambivalent institutions, weak routines, or lack of experience in case something goes wrong (Krug and Polos 2004) plus *political hazard*. Apparently weak

institutions at the aggregate level manifest themselves as conflicting regulations, state intervention, and ad hoc appropriation of profit or cash flow by government agencies at the level of the firm. Unlike other transition economies where the *primacy of property rights-view* led to (central) state investment into institutions, such as law enforcement or capital markets that strengthen private property rights, Chinese economic actors need to search for other ways to protect assets and the value of business relations. In order to survive in such kinds of uncertainty firms need to find an organisational form, which mitigates the political hazard, and copes with procedural risk while preparing itself for market competition.

The Chinese solution can be called *corporate governance* in its widest sense referring to governance structure of firms irrespective of their origins - socialist or otherwise. The fact that Chinese firms change their organisational structure more than once finds its explanation in the fact that corporate governance is responding to more than ownership questions. A governance structure needs to be established that allows coping with risk and innovation[5].

Some localities in China still have firms with unspecified property rights where a community, as is the case with the TVEs, or a general bureaucracy claim *quasi-ownership*. Yet most firms today are based on informal partnerships (as in the IT-sector) or formal and registered (corporations) property rights regime. While the share in overall output of firms or SOEs working under an unspecified property rights regime has declined drastically in the years since the introduction of the Company Law (1994) with the result that the private sector contributed between 63 per cent and 71 per cent (collectives included) in 2003, this does not mean a complete retreat of the state sector. Fieldwork (Krug and Mehta 2004; Krug and Hendrischke 2005) or case studies (Hendrischke 2003) show that bureaus, i.e. branches of national bureaucracies, or local government agencies keep a minority share in even privately established companies. They receive or can bargain for a share, as this is seen as a way to replace their grasp on cash flow with dividends and limit their impact (vested interests) on managerial decision-making. By doing so managers and entrepreneurs attempt to better align

their interest (Nee and Peng 1994) with that of government agencies. To the extent that these agencies profit from firms either directly (share on profit, tax revenue) or indirectly (investment, workplace generation, increase in land value) they have an incentive to co-operate by offering an attractive business and investment environment. The co-operation strategy leads to lower political and procedural hazard when local agencies protect the firms' assets and business relations.

The organisational form of firms also differs with respect to the distribution of risk. Incorporating firms not only hardens property rights, at the same time it allocates risk to specified owners. As mentioned earlier, shares in the hands of government agencies expose them to risk and sets incentives to co-operate. Firms can spread risk also via networks (described below) and to other public or private investors when they mobilise (venture) capital outside the official channels (Batjargal and Liu 2004). Finally, depending on HRM-practices (selection, incentive work contracts) a firm can shift part of the risks to employees, in particular unskilled workers (Dong *et al.* 2002). The allocation of risk to the last two groups will not be revealed in registered capital, but depends on specific intra-firm written contracts or the embeddedness of a firm in a network.

So far the property rights and risk consideration suggest an efficient "loss-management" for firms, and indeed strong incentives for rent-seeking. Yet the spectacular success of the Chinese firms can hardly be explained without the governance structure that allows distributing the innovation rent within firms and between firms and the share- or stakeholders. In transition economies innovation is dominated by technical innovation but includes managerial skill, as for example the talent and ability to change the organisational form of firms. Firms differ with respect to the premium they offer to technical as opposed to organisation/institutional innovation as well as the premium they offer to managerial competence as opposed to capital ownership. While technical innovation is increasingly linked to the entrepreneurial rent in the private sector depending on access to venture capital,

organisational innovation depends on incentive contracts with managers. On the one side there are the managers in SOEs, still tenured and paid according to the cadre/nomenclatura guidelines, who have few incentives to search for new products or productivity increasing factor combinations. On the other side there is the extensive use of crop-sharing contracts (Cheung 1969) where villages (or government agencies) as leaser and (new) managers as lessee negotiate the sharing parameter of the innovation rent (and risk) (Krug 1997, Li and Rozelle 2003; Dong *et al.* 2004). In the past most privatised TVEs (see overview in Li 2005) relied on management buy-outs where managers could convert their accumulated profits into shares. To dismiss this as insider trading or an indicator of corruption is to miss the point (for example Li 2005); what matters is that a governance structure was chosen which put a high premium on the innovation of managers and, by doings so helped transfer ownership to those who had been proven to be competent.

In short the development of new forms of corporate governance was initially negotiated between managers, government agencies and networks while new economic actors, such as employees, capital owners and lately banks emerged due to market development and these interactions. With the expansion of capital markets as markets for risk, registered private property rights, and the increasing use of incentive contracts for scarce managers private firms will continue to outperform SOEs and other governance forms that know no incentive work contracts. Under those circumstances it is not hard to predict convergence to incorporated firms. The question is rather whether there are limits to this convergence and whether these limits imply a spatial dimension so that we can expect diversity to contribute to the development of different "sustainable" business systems.

To answer these questions two trends and two institutional constraints seem exceptionally important: The *expansion of markets* will lead to more choice in how to co-ordinate inter-firm activities and at declining transaction costs. Thus, localities where (more) markets function better will see a higher concentration of organisational forms that reflect pure economic

considerations. This is in contrast to localities where large SOEs constitute a considerable part of the industrial structure and where therefore not much can be gained for local government agencies and local firms from co-operating. *So long as the national state protects SOEs they might be driven to the margin of markets but can still control resources* (Krug and Polos 2004).

Networking as transaction cost saving device

To claim without further empirical evidence that Chinese networks – labelled *guanxi*-(personal) *relations* - are unique and therefore require a completely new social science approach has obfuscated the issues with general references to cultural values. To explain how networking which indeed is widely used in China works as a transaction cost saving device, a fresh look based on empirical studies ((Gold *et.al.* 1998; Wank 1996; 1999, Yang 1994) is needed. As will be seen presently, the usual analysis of trying to explain networks as hybrids (Williamson 1985) by referring to different transaction costs according to firm size, sector, technology used, is overshadowed by transaction costs which reflect the initial condition all transition economies find themselves in and by the China specific institutional architecture as described earlier.

From the point of view of individual economic actors in transition economies the market-hierarchy dichotomy remains an abstract concept hard to reconcile with the necessity to solve economic problems, such as how to establish and run a firm, or how to find customers and suppliers. In general, economic actors face the alternatives of either doing something alone, *or to embark on economic activities together with others*, or to ask government agencies to provide those goods and service private economic actors find too expensive or risky to organise (Powell 1990; Coleman 1986; Ostrom 1990; Greif 1993). With ill-functioning markets and shrinking co-ordination by the old state sector, private collaboration offers a high

co-operation rent and is unsurprisingly not China-specific but rather referring to the role of social capital in the transformation process (Grabher and Stark 1997; Nee and Stark 1989, Stark 1996; 1998; see also Boisot and Childs 1988; 1996). *The effect networking has on economic outcomes depends on the internal governance, network functions, and the interaction between networks and the different layers of government agencies.*

In the Chinese version, networks are a social mechanism for co-ordinating economic activities in which *mutual trust, affinity, norms of reciprocity and reputation limit moral hazard and define sharing rules* (Jacobs et.al.2004; Redding 1996; Hendrischke 2006; Bian 2001; Yang 1994; 2002). Networks emerge when economic actors individually or by collective consensus opt for using this form of social mechanism. Though primary groups, such as the family, classmates, colleagues or friends, form the hard core of networks the scale and scope of the networks is not limited to a predefined pool of trustworthy and likeable people (Hendrischke 2006). This has to do with the open boundaries, and low entry and exit costs: Individual economic actors can be members of several networks. To change from one business relation or from one network to another is seen as neither a breach of contract nor a breach of loyalty. Subsequently, the sanctions for doing so remain low. When a business relation no longer offers expected returns, the relation will be “de-activated” but not ended in the sense that both partners remain socially connected as friends, colleagues, or family members. If enough individual actors do so then a network stops functioning as a mechanism for co-ordinating economic activities, yet retains its social functions. Likewise, entry to a network works via social acceptance as trustworthy and competent, judged by the fact that an outsider is doing business with one network member.

In the language of economic sociology such networks allow smooth switching from weak to strong ties (Granovetter 1973; 1983). Individual economic actors will embark on networking when they expect that networks offer a more effective means to co-ordinate resources and activities than either the market or the discredited state bureaucracy. Individual

economic actors benefit as networks help to find a "matching" business partner and turn an anonymous into a particularistic relation (Pfeffer et al. 1976; Peng and Luo 2000, an example for the labour market is given in Bian 1997). To know that one's business partner is suitable, competent and reliable means that the cost component covering relational risks can be diminished or reduced. Therefore, networks contribute to the emergence of markets when prices/values of assets and business deals become less vulnerable to moral hazard. More important in a dynamic view is the effect that prices and exchange values reflect more exclusively scarcity, marginal costs or quality, which allows employing resources at their best use and thereby contributing to overall allocative efficiency (Batjargal and Liu 2004). This interpretation stands in clear contrast to the networking equals rent seeking equals corruption view which prevails in the analysis of other transition economies (Shleifer and Vishny 1993; Cheung 1996). These stress the incentives for a network to embark on rent-seeking activities. In a dynamic interpretation two other features are important for explaining the diversity and limit to rent-seeking. First, underperforming networks are not driven out of the market. Instead, they turn into *dormant* (Kuilman 2005) organisational forms, whose social capital or other assets can be re-activated (at low costs) should relative prices and rates of return change. Second, networks are nevertheless subject to competition. It is a form of *diffused competition* (Hannan and Carroll 1992) less steered by changes in prices (or marginal costs) of producers than by changes in attention or interest on the demand side.

In order to get and remain activated as a co-ordinating mechanism for economic activities, networks need to fulfil (economically) valuable functions. For this reason networks need to produce satisfying outcomes for their members. They are established to overcome a *resource constraints* (physical assets, human capital, lack of technology) by offering a governance structure for pooling resources (Peng 2000; Krug and Polos 2004), and *institutional weakness* in form of ill-functioning markets, ill-defined property rights, and the ambiguity of the reform course by offering private property rights protection, "contractual"

security, and access to market information (Wank 1999; Peng and Luo 2000; Xin and Pearce 1996). Further functions of networks is to tackle the *public goods problem*, more precisely the lack of investment in infrastructure, market-conforming education, or the judiciary by investing and operating public utilities, private labour bureaus and vocational training, but also law and accountancy firms. Another aspect is that networks also offer a social mechanism where hard-to-exchange information, knowledge and experience can be jointly produced and shared, and thus the "liability of newness" (Krug and Polos 2004) in the new private sector be mitigated. Finally, networks fill the *institutional vacuum* as perceived by economic actors when they formulate concerns, if not expectations, to be negotiated with (local] administrations to jointly search for "suitable" rules and regulations (Hendrischke 2003; Oi 1995; Walder 1995).

A second requirement that needs to be fulfilled so that networks will function as economic actors is their governance. They need to limit free riding, while keeping incentives for voluntary contributions in form of information sharing and co-operativeness. As field studies have shown it is *reputation* and the system that one member vouches for the trustworthiness of the new entering member proposed which serves as an effective enforcement device (Hendrischke 2006).

Local Autonomy as a means to reduce the costs for institution building

The functioning of local autonomy and its contribution to overall transformation and development depends first on the governance of public-private relations within the jurisdiction, and second on the governance of inter-jurisdictional activities. To start with the former, although local autonomy in China has a resemblance to the "commons" or Jointly Owned Resources (Ostrom 1990) the village-owned land on the one side and manager controlled physical assets on the other side suggest to better view local autonomy as a

constrained co-operation game (Greif 2003) between local government agencies and managers (entrepreneurs) as those groups which control the resource base of a locality. Both share an interest in economic growth of the local resource base, as each benefits from overall growth. Therefore both groups have an incentive to co-operate. Each group can increase its resources by investing in the resource base and by changing the sharing parameter to the detriment of the other group. Government agencies appropriate their share via (income) taxation, land prices, direct resource control and other forms of intervention, while firms can secure a satisfying share by moving (or threaten to move) to another jurisdiction offering a better “deal”, or moving into other, less controlled, lines of production (exit), or by individual contracting over net taxes (tax base, tax rates and tax exemption) and collective bargaining. The relative bargaining position of firms is constrained by sunk costs or asymmetric information and corporate governance, while local governments need to acknowledge institutional constraints on their autonomy, more precisely interventions from superior administrative agencies. Each group can however improve its bargaining position by mobilising support both from ‘above’. A stable business environment will occur when both local groups have no incentive to change institutions, if for example the resource partitioning is accepted, none has an interest to mobilise support from above thus inviting intervention, and when the upper level government agencies see no reason to interfere.

It is this co-operation game, which allows economic and political actors converting “demand” for corporate governance into a corresponding supply. Local government agencies can turn informal business practices that have been tested or emerged in the course of frequent business transactions into a formal architecture, which then gets enforced by local government agencies. The need to co-operate ensures that economic entrepreneurs participate in such a “legislative” process and in the insistence on implementation.

All in all, local autonomy offers a way to agree on new or remembered governance structures at low costs, yet at the local level. Whether best practices get copied and thus

expand beyond the lowest level of government agencies depends on economic incentives as inherent in the formation of industrial districts, the competing overlapping networks, and the interaction between different layers of government.

Conclusion

The devolution of power at the beginning of the reform process introduced local autonomy thereby stimulating diversity in regulatory power. Yet, locally defined forms of governance form only one part of the emerging local business systems as the central political leadership is no longer the sole supplier of institutional change. Instead the local business systems depend on political and economic entrepreneurship, more precisely the interaction of these two groups. The cooperation of these two groups is shaped by the formal architecture of local autonomy and the informal institutions of networking. In a *comparative perspective* this interaction as well as differences in the underlying driving forces for co-operation, namely: procedural uncertainty, relational risk and institutional change, must lead to diversity in outcomes. Diversity in corporate governance translates into diversity in local business system. In a *dynamic view* both market competition and networking will ensure further jurisdictional competition, while on the other hand imitation and scale economies will ask for convergence of local business systems beyond. the local nexus (regional business systems). As the analysis presented here suggests three factors will influence the boundaries of the evolving business system. First, political "unification" when the central government or several local states decide to "harmonise" the institutional set up. More intriguing it whether we can observe a process by which several local jurisdictions "converge" to similar governance structures. Second, the technical-economic process by which industrial districts emerge, i.e. positive externalities when (skilled) labour and intermediate goods are pooled, and knowledge is shared leads to the concentration of certain industries. Third, the emergence of regional

"regional" networks revealing shared business practices and "habits", but also successful lobbying.

Two further findings are noteworthy: The primacy of private property rights-view of economic transformation needs to be newly assessed. China suggests a primacy of "private exchange"-view offering additional evidence to historical studies (Greif 1993; Tilly 2001) which show that the expansion of free markets often preceded the introduction of private property rights. Similarly, China also supports those studies (Tilly 2001) where it is claimed that in historical terms networking or social capital has always been the third mechanism by which large scale organisations such as economies co-ordinated their activities, more precisely that the market-hierarchy dichotomy was a rather recent phenomenon and on of a transitory nature. In other words, it is cautiously suggested here that China will end up with a decentralised form of network-capitalism.

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[1] In a democratic context this would be called the "Constitutional level" (Buchanan and Tullock 1962).

[2] A detailed analysis can be found in Krug *et al.* (2004), Zhu and Krug (2006).

[3] Another evidence is the establishment of new regulatory bureaucracies, such as the Administration for Industry and Commerce, or the Quality Technical Supervision Bureau both of which aim at monitoring and standardizing commercial practices (Mertha and Zeng 2005, p. 331).

[4] Likewise, size of (expected) demand is crucial for the emergence of entrepreneurship and inflow of investment (Shleifer and Vishny 1988).

[5] While international organisations such as the World Bank or the OECD distinguish only between the state, collective and private sectors, assuming that the collective sector is more or less a kind of private sector (Economist, 17.09.2005), the Chinese classification system still reflects the administrative needs of its socialist past, amended by "self-employment", private business, holdings, or TVEs, joint ventures and wholly-owned foreign companies. Any empirical analysis relying on these data runs the risk of overemphasizing political factors (as for example Walder 1995; Guthrie 2005), thereby missing the impact of economic development, such as specialisation gains, market and income differentials on the change of organisational forms (Nee and Cao 1995).

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