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Framing China: Transformation and Institutional Change through Co-evolution

Barbara Krug[1] and Hans Hendrischke[2]

[1]*RSM Erasmus University, The Netherlands, and* [2]*The University of New South Wales, Australia*

ABSTRACT This paper proposes a new institutional perspective to explain not only the diversity of local business systems in China but also how this diversity results from the integration of major institutional forces. We model the emergence of China's business systems as a co-evolutionary process unfolding along a business–government and a micro–macro-level dimension structured by intergovernmental institutional competition, business to business and business to government networking and public–private corporate governance. We find that: (i) China's emerging business system is the result of local institutional competition at the micro level that reduces the need for national (macro) institutions and impacts on the local implementation of national (including supranational) policies; (ii) the interaction between government and business is structured through networks which operate according to an economic rationale while drawing on cultural norms and traditions; and (iii) local businesses interact with local governments to recombine productive factors and reorganise firms and industries in line with local institutions. We conclude that the astonishing adaptability of Chinese businesses as well as the risk of corruption and lack of formal control at local government level are elements of locally differentiated business systems which are held together by an overarching institutional architecture.

KEYWORDS China's business system, co-evolution, decentralization, institutional change, local autonomy, networks

INTRODUCTION

China's economy is evolving by experimentation with a variety of locally based economic regimes where increased market efficiency – and subsequently economic transformation – depends on the decision-making powers available to local governments and businesses and on institutional innovation through coordination (i.e., incentives and governance) in the form of private exchange between these new political and economic actors. 'Local' refers to the subprovincial level, where the majority of China's businesses are registered; 'government' refers to the local state which includes local Communist Party organisations. The resulting variety of local business environments puts in doubt whether or not China is on its way to achieving an integrated market, uniformity in institutional architecture and conformity in economic behaviour that would add up to a single business system. We focus on local business systems and exclude aspects of the broader economic system, such as redistribution, transfers, entitlements (health, or old age) and monetary policy. Our analysis uses an institutional perspective to explain the diversity of business systems within China as a result of the interplay of major institutional forces. We address four gaps in research literature.

First, we explain the diversity of business regimes. The heterogeneity of business environments across China is a well-established fact, supported by China studies (Fitzgerald, 2002; Goodman, 1997; Hendrischke and Feng, 1999; Oakes and Schein, 2006; Wong, 2002) and the well-documented difficulties of foreign firms in building up a nationwide 'China competence' (Wu, 2006). The business administration literature has so far failed to offer an explanation for the variety of business systems within China and instead subscribes to the notion of a homogenous authoritarian state or overarching cultural (Confucian) values. 'Classics' such as Redding (1990) and Hamilton (1996), and more recently Peng and Zhou (2005), assume a general and uniform change in resource control, state intervention, or law enforcement. The gap between practical experience and academic reasoning calls for an analysis of China's institutional architecture which accounts for the coexistence of local business systems with the integration of markets, a coherence of political institutions and conformity in behaviour which seem part of an emerging national Chinese business system.

Second, we explain the formation of local business systems through the interaction between local businesses and government. Links between local businesses and local governments are well documented in the China literature on local state corporatism and state entrepreneurialism (Chen, 2007; Duckett, 1998; Gold, Guthrie, and Wank, 2002; Nee, Opper, and Wong, 2007; Oi, 1995), but these descriptive approaches generally do not include a transaction cost perspective or focus on the implications for local corporate governance and business systems. Meyer and Peng (2005), in their excellent overview, have drawn attention to the institutional constraints which generate transaction costs at the firm level, but missing here is the political context and its effect on entrepreneurship, innovation and organisational form of firms. Research techniques proposed by Greif (2006) and Lewin et al. (1999) are useful in assessing how businesses cope with institutional change in specific political and cultural environments, covered below.

Third, we explain the role of culture in the evolution of business systems. Chinese culture has long been used to explain local institutional structures. We reject essentialist cultural explanations for China for their disregard of historical and economic factors (see also the critique by Huang, 2003, pp. 21–24), their sweeping assumptions about the spatial and social dimension of cultural values and their reductionism in, for example, labelling Chinese entrepreneurs as acting as 'clan' (Batjargal, 2007). Following the arguments of economic historians (e.g., Faure, 2006) and insights from modern China studies (e.g., Goodman, 2007) our institutional perspective acknowledges culture in the form of tradition (Nelson, 1993; North, 2005) which can be drawn upon to solve coordination and motivation problems linked to economic activities. We see culture as a repository of potential coordination mechanisms and informal institutions which are likely to emerge at the micro level and are open to empirical institutional analysis.

Fourth, we explain the evolution of a local non-state (TVE) sector and private firms in the absence of national institutions. The emergence of new economic actors, such local businesses and local government agencies is the result of institutional change (Nee and Lian, 1994) that happened without formal national legislation. As these actors are simultaneously recipients and instigators of further institutional change, their interaction at the local level as well as their interaction with higher hierarchical levels needs to be analysed (see also Aoki, 2001; Williamson, 1985). While the conventional unit of analysis in management science has been the firm, new approaches acknowledging the importance of business relations in the form of networking, collaboration, or strategic games (Hamilton, 2006; Lawrence, Hardy, and Phillips, 2002) need to be expanded to capture institutional dynamics, in particular how institution building at the local (micro) level reduces the demand for national (macro) institutions and impacts on the local implementation of national (including supranational) policies (see for example the careful analysis by Nee and Cao, 2004).

CONCEPTUAL FRAMEWORK

Conventional neo-classical theory claims that (market conforming) co-evolution occurs if and when new exogenously given institutions at the macro level, such as market competition, increase the effectiveness of micro-level institutions, such as private contracting (Lewin, Long, and Carroll, 1999). We find that in China the reverse mechanism can be observed in the form of endogenous institution building, where the increasing use of (micro-level) institutions such as the public–private cooperation in establishing firms creates demand for and increases the effectiveness of (macro-level) institution such as property rights and contractual security. We suggest that from a co-evolutionary perspective, China's emerging business system is the result of the interaction of endogenous and exogenous forces in a two-dimensional structure with government–business as the one dimension and micro–macro level as the other (Barley and Tolbert, 1997; Hensmans, 2003; Lawrence et al., 2002).

The local, micro-level business sector is the primary and endogenous force for the co-evolution. Its dominant role derives from its ability to co-opt the local government sector and, in the process, weaken local government subordination under the macro-level higher echelons of provincial and national government.

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Micro-level institutions can be found in the formal and informal rules governing the local business sector; for example, links between local firms or relationships between local businesses and government agencies. These institutions serve the interests of local economic development.

Examples for macro-level institutions can be found in political and financial devolution, national legislation, WTO regulations or the commitment of the Chinese Communist Party to market reform. It is noteworthy that these institutions rely on negotiation and bargaining as much as on hierarchical rule. The policy consequences of governing by bargaining and negotiation are well documented (Faccio, 2006; Fisman, 2001; Li, Feng, and Jiang, 2006; Rona-Tas, 1994); the institutional consequences will have to be drawn out in more detail. The micro–macro-level dimension links local and national (including supranational) levels in an interactive institutional continuum which creates space for local institution building.

The macro-level government sector provides the initial trigger for the co-evolution by creating an institutional space at the local level through devolution of power and through the weak enforcement of hierarchical rule, such as the rule of law or a stringent tax regime. Once the local institutional space is taken up by endogenous forces and economic growth ensues, the macro-level government sector has an economic incentive for co-evolution in the form of reduced or selective interference. From a co-evolutionary perspective, the imposition of institutional constraints by the macro-level government becomes a question of how to improve the existing, decentralized institutional framework without jeopardizing its successful operation.

In historic terms, the co-evolutionary process started with the initial commitment of the Communist Party to market reforms (1978) which were regarded as (exogenously) given. The downwards transfer of decision-making powers and resources to local businesses and local governments, the opening up of the economy for foreign investment and international competition, coupled with the reluctance to establish and centrally enforce private property rights, led to specific features in cooperation and competition which characterise China's emerging business sector (see Fig. 1).

The co-evolutionary approach requires analytical separation of the government and the business sector as two distinct areas. Government sector decentralisation, which transferred regulatory power and resources to government agencies at the provincial and subprovincial level, is in itself insufficient to explain the resulting institutional features. Local business regimes and diversity in local jurisdictions depended on the way in which local government agencies responded to the downwards shift of resources and regulatory power by co-opting local businesses (see Fig. 2).

Institutional change in the business sector mirrored this process. The initial commitment of the reforms empowered individual actors to control (and, since 2004, own) resources, start companies and become the (residual) claimant of a

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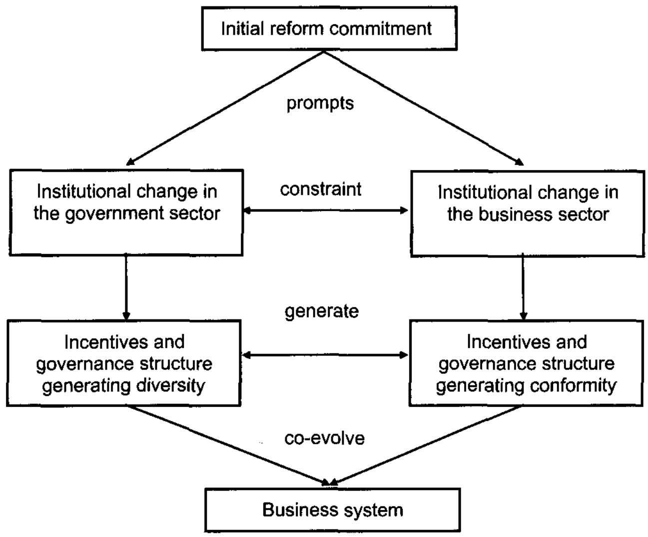

Figure 1. The emergence of the Chinese business system

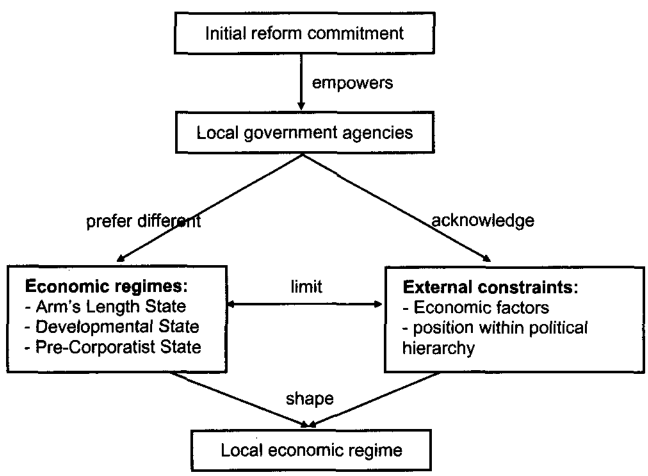

Figure 2. Institutional change in the government sector

firm's profit. Fragmented markets, asymmetric information or state intervention are not enough to explain the emergence of a private sector. It was rather the way economic agents overcame institutional uncertainty (which weighed more than relational uncertainty of the Williamson transaction cost type) by devising new forms of corporate governance, networking and collaboration with local government agencies. The resulting new organisational forms aimed at a 'loose coupling' of ownership rights and resources as a more flexible way of exploiting new business opportunities (see Fig. 3).

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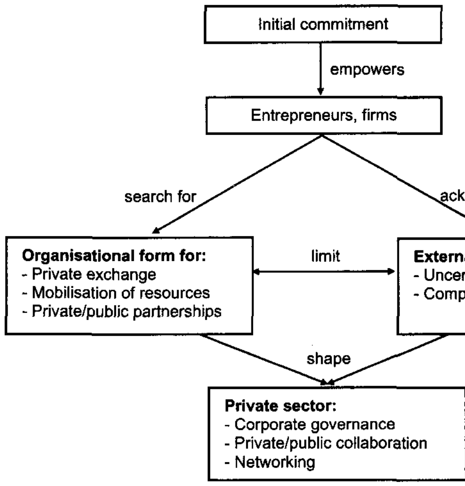

Figure 3. Institutional change in the business sector

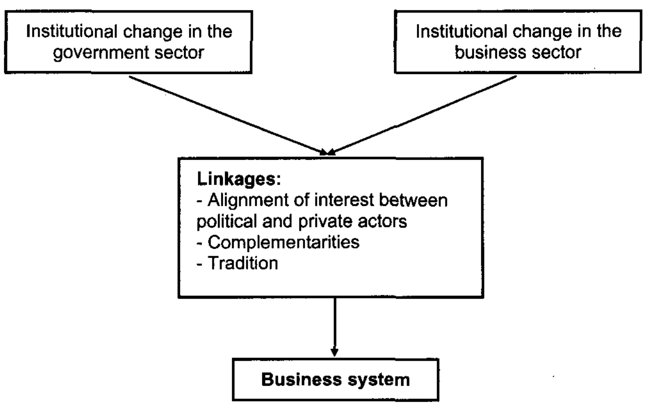

Figure 4. Co-evolutionary process in China

This stepwise analysis points to the linkages between institutional change in the business and the political sector. Complementarity and alignment of interests between businesses and governments mark the co-evolutionary path (see Fig. 4).

Ultimately this co-evolutionary path enables local differentiation and adaptation to specific circumstances and defines the overarching framework of a (national) business system.

These conceptual preliminaries set the framework for analysing the underlying institutional architecture and the incentive structure which motivates local businesses, local governments and central government agencies to coordinate their economic activities in a seemingly paradoxical fashion that assigns each of them a duality of functions, which makes them recipients and instigators of institutional change at the same time. Obviously, such a structure cannot be explained by the standard tools of institutional analysis which assumes the existence of unambiguous rules and non-ambivalent relationships. Before taking a closer look at corporate governance, networks and intergovernmental competition from the perspective of what has been explained above, some comments on methodology seem to be necessary.

METHOD

To respond to the challenge this paper sets for itself, the analysis needs to expand the research landscape and import additional analytical tools. So far the co-evolutionary perspective has explained the emergence of new products or production processes and the renewal of firms and industries from the interplay between technology, knowledge or innovative systems. Our analysis concentrates on the interplay between the government and business sector and the 'renewal' of organisational forms and institutions governing business relations where the outcome is 'new' firms and 'new' business practices. The argument that the co-evolutionary perspective requires the study of organisational forms over time (e.g., Lewin et al., 1999; McKelvey, 1999) assumes that firms exist in the first place. Concentrating on existing firms in China would reduce the scope of inquiry to state-owned enterprises (SOEs; as in all the World Bank, 1994, sponsored 'overviews': Garnaut, Song, Tenev, and Yao, 2005; Guthrie, 1999; Nolan, 2001) and foreign invested companies which indeed dominate the analysis in the management literature. This limits the analysis to a 'population' which contributes no more than a third (or 40 percent, depending on data) to overall domestic output (OECD, 2005, Tab. 2.1, p. 81). For China, the dynamics at the local level have to be included, in particular township and village enterprises (TVEs). The latter had become the motor of growth in the 1980s, generating up to half of total value added, profit and output (Li, 2005, pp. 198–199), but are under-researched as the backbone of the emerging private sector (for exceptions see Garnaut et al., 2005; Li, 2005 and literature quoted therein, pp. 212–213).

The research design needs to consider that a great part of the heterogeneity of local business systems finds its explanation in informal institutions and local implementation procedures which are not published. Interviews provided the best access to information as long as they served two purposes. First, to 'construct' the institutional landscape at a specific location; and second, to 'construct' the process of institutional innovation, i.e., the rationale, motives and constraints behind the decision-making of economic and political actors. We used a method known as analytical narrative (first described in Bates, Greif, Levi, Rosenthal, and Weingast, 1998) which relies on combining institutional knowledge with the analytical toolkit in New Institutional Economics, modern management studies, and organisation theory. This was achieved by parallel sets of interviews with government officials and business people in the same location and the elimination of information that could not be cross-verified.

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The Interviews

The interviews are location specific. Thus, the landscape as described below defines the spatial explanatory power of our findings. While this limits the spatial validity of our findings, it excludes unjustified generalizations across institutional borders.

Interviewees

The interviews occurred during the period 1998 to 2004. As the research focused on private, domestic firms, those companies which turned out to be a joint venture partner, an SOE, or not independent (in an accountancy, or profit recording sense) were later excluded. Similarly, interviews in 2003–2004 with representatives of the local and national tax bureaus were also kept separate. Thus, the findings rely on 104 formal interviews with managers and owners, plus 15 formal interviews with tax authorities. These interviews were complemented by semi-formal open-ended interviews with local government and Party officials for background information.

Location and Time

The interviews cover three provinces: Shanxi, Zhejiang and Jiangsu, with the latter two dominating. Our identification of features of emerging business systems are therefore based on the richest provinces in China. The time frame covered by the interviews is the period of intense privatization in Zhejiang and Jiangsu.

Size of Firms

Although the interviews cover a broad variety of firms ranging form a 'headhunter' (one owner and one secretary) to a machine tool firm employing 1,000 employees, the sample is dominated by 'middle scale' firms, which employ between 25 and 200 people. Classifying firms by turnover proved difficult, as information provided was not trustworthy.

Age

The firms were on average six years old at the time of the interviews. 'Greenfield investment' was rare and concentrated in 'modern' (IT or service sector) industries. Half of the firms grew out of rural or urban collective enterprises or small local SOEs. As a consequence of mixed information there is an arbitrary element in the classification of firms by origin.

Industries

We encountered problems with classifying firms according to sector. The question about the 'core business' often could not be answered when firms were engaged in different, unrelated sectors. The light industry sector, such as textiles and IT, played a prominent role in the two southern provinces, while in Shanxi, machine tool manufacturing such as bearings and fittings and transport linked industries (trucks or tires) dominated.

Questionnaires

The standardised part of the questionnaires underwent several revisions. It was less the technical linguistic problem which made revisions necessary than the need to incorporate new information learned during previous interviews. For example, after we learned that taxes were partially negotiable, the technical question about pre- and after tax profits were replaced by more flexible questions. In particular questions about privatization had to be adapted to local circumstances. In the end the open questions about the life history of the firm proved to be the most valuable for learning about both the local institutional landscape and the reasoning why political and economic actors agreed upon certain new institutions and forms of organisation.

The questionnaire followed certain topics. Thus after the socio-demographic data (part A) was presented, the above questions concentrated on (Part B) ownership, management of risk and the organisation of decision-making (V89-105). An illustrative example is the question 'Do decisions regarding . . . need further approval by local government agencies, banks, or a collective?' Another topic was the firm's configuration of business/social relations (Part C) where we asked, for example, 'How important is a relationship with . . . for the success of your firm: essential, important, unimportant, not applicable?' Alternatives given were SOEs, government agencies, the village communities, the family or other groups that the respondents were asked to specify.

In Part D the respondents were asked to choose one business relation and answer the following question with this one business relation in mind. One set of questions concentrated on the reasons for the business relation (V119-166). We asked for economic factors (price, quality, efficiency and specialisation effects) and cooperativeness, i.e., the 'willingness of X to invest in capital, time or effort to meet your firm's need' with some situations specified (lack of technology, natural hazard, illiquidity). We also asked for valuable business contacts, i.e., whether the partner offers 'further business contacts (Guanxi) elsewhere in the province, China or the World' or access to political and state agencies. We were, finally, interested in trust when we asked which kind of information (e.g., costs, business opportunities) would be voluntarily shared.

Another set of questions asked about the use of (written or unwritten) contracts. We asked about the content of contracts such as price, minimum quality or product specification), but more importantly about enforcement (V173-V202). Thus we asked whether the firm has the right to inspect the partner's firm, about the definition of force majeurs, whether the recourse to law was seen as an efficient enforcement mechanism and, if not, what other ways of arbitration would be used.

Data Analysis

Cross-case examination was secured by discussing the cases with colleagues participating in the interviews, colleagues involved in field work in other parts of China and published empirical research. Yet, the decisive tool for interpreting the cases has been their confrontation with the concepts and theories as developed in New Institutional Economics and as introduced in the text (Bates et al., 1998; Mäki, 1993, 1999).

RESULTS

Institutional Change in the Government Sector

Though at first not part of our questionnaires which concentrated on firms, the interviews with owners, managers and later local government officials in different counties taught us to question the usual frame which assumes that the Party or the State defines both a separation of power between different layers of a decentralised government and the range of different acceptable policies. Most of the existing literature fails to operationalize what is meant by the local state. Whether the 'fiscal federalism' argument (Qian, 2000; Qian and Weingast, 1997); general discussion in Oates (1972) or the empirical studies on 'central-local' relations (Brean, 1998; Gong and Feng, 1994; Wong, 1992, 2002), existing studies are unspecific when it comes to which level of government or administration is involved in which kind of regulation or taxation. The interviews, in particular the life histories of firms, offered the insights into the functioning of the political institution. For example, we learned that the devolution of regulatory power does not stop at the provincial level, meaning that as long as neither the Party nor superior government agencies object, each local jurisdiction can opt for its own mix of regulation and taxation. Uniquely for a transition economy, government agencies at all levels can 'farm out' regulatory power and policy implementation in return for negotiated revenues (a detailed analysis can be found in Zhu and Krug, 2007). Subsequently, the 'mix' of regulation and taxation is subject to permanent bargaining and contracting within the administration and between the administration and the business sector. Such a form of decentralisation needs to be seen as a move by which the central government secures support from the lower administrative agencies on whose compliance the enforcement depends. Coordinated via contracts with the superior agencies or informally via networks, such an authority and tax sharing system enables local governments to capture the gains 'at the margin' and thus directly profit from local economic development (see the different contributions in Brean, 1998; for a comparative view see Litwack, 2002; Shleifer and Vishny (1993, 1994).

Institution building in the government sector is, therefore, an ongoing process where the political and 'ideological' preferences play a role not in the form of an explicit statement towards the role of the State or the Party, but by selectively opting for certain policies, while paying attention to some external constraints.

Diversity in Economic Regimes

Depending on political preferences and empowered by decentralisation and 'farming out' policy, different sets of institutions, i.e., different types of economic regimes, can be chosen by different localities. For analytical purposes the different sets of institutions can be identified by three forms: the 'Arm's Length State' is best imagined as the regime that comes closest to the neoclassical state; the 'Developmental State' is one in which state agencies control sectors and plan economic development; and the 'Pre-corporatist State' is where the state delegates authority to certain social groups which, different from the usual definition of a corporatist state, do not need to be formally recognised (Schmitter, 1974) (Table 1).

At the most general level the three types can be distinguished by the following features.

1. Involvement in development and transformation. In the Arms Length State the State remains aloof, as a neutral arbitrator, limiting itself to a set of tasks defined by the provision of public goods and connected with national sovereignty. In contrast, the Developmental State sees itself as a dominant planner and regulator of economic development. To do so, government agencies will be established that directly control resources, protect industries or offer monetary incentives for politically agreed upon economic activities, such as investment in R&D or education. The Pre-corporatist State establishes and safeguards its legitimacy by authority sharing with social groups whose cooperation is perceived as essential for economic development.
2. The scope and nature of voluntary business relations. The Arm's Length State is characterized by rule-based governance and an (independent) judiciary guaranteeing contractual security for business partners. The Developmental State in contrast defines (sector-specific) constraints for those economic activities over which the State claims control, which in turn will be enforced by a professional bureaucracy. Voluntary exchange (or investment) is thereby limited to sectors outside state control. In the Pre-Corporatist State

Table 1. Economic regimes

Key characteristics	*Arm's Length State*	*Developmental State*	*Pre-Corporatist State*
Involvement in development and transformation	State as neutral arbiter Low taxation small range of regulation	State as planner and regulator resource control Planned development	State as 'partner' Authority sharing
Scope and nature of voluntary business relations	Contractual relations between equal judicial persons	Sector-specific control	Bargaining with the corporate sector
Organisational choice	Toleration of new organisational forms	Sector-specific organisational forms	Fuzzy organisational choice
Property rights regime	Individual, private law	Public-private	Collective consensus
Innovation and experimentation	Market driven R&D firms	State education State R&D	Network driven
Selection, economic performance	Competition	State defined constraint	Internal negotiation
Standardisation technical and business practices	Investor driven Market wide	Technical/sector wide	Inertia Random change

business relations depend on bargaining within the corporatist sector while voluntary exchange is limited to activities not claimed by 'networks'.

3. Organisational choice. The Arm's Length State tolerates all forms of cooperation and organizations as long as their purpose is not to limit competition – such as monopolies. The Developmental State in contrast establishes state controlled monopolies or cartels, defines entry barriers for newcomers, often including specific requirements for the organisational form. In the Pre-Corporatist State, networks emerge as the dominant form for organising production and exchange. Whether network supported sectors develop into state guaranteed (local) monopolies depends on the interaction between these networks and the political leadership.
4. Property rights regimes. While the Arm's Length State establishes private property rights, the Developmental State limits those to resources and sectors over which the 'public' does not claim control. The Pre-Corporatist State knows a large range of collective property rights where individual interests get represented by a collective actor.
5. Innovation and experimentation. In the Arm's Length State innovation is market driven with firms and their R&D department as major agent. The Developmental State attempts to steer innovation via planning, formal education, or the establishment of science parks supervised by a group of

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professionals within the state bureaucracy. In the Pre-corporatist State innovation and experimentation depends on the cooperation and support of those groups, which can mobilize the necessary resources, such as local 'power holders', networks or Party members.

6. Selection, economic performance. Which business venture succeeds or fails is decided in the Arm's Length State by market forces, i.e., competition, while in the Developmental State technocratic entry and exit criteria supplement market forces. In the Pre-Corporatist State where individual property rights are weak, performance depends on the evaluation criteria of networks or are negotiated between networks.
7. Standardization of technical routines and business practices. Finally, the establishment of (technical) routines, or business practice, is driven by market forces in the case of the Arm's Length State. In particular, investment flowing into that routine or practice that promises the highest returns will ensure that the best practices are imitated across sectors. In the Developmental State standardization follows decisions within the state bureaucracy, while in the Pre-Corporatist State standardization is either missing due to group-specific protection or appears as random change.

The case of China is instructive; one of the most striking features of the Chinese economy is the coexistence of all types of economic regimes established by different layers of government. For example, our interviews in 2004 in Wujiang City near Suzhou showed that the city (county)-level admininistration 'planned' industrial development. Local agencies defined industrial as opposed to commercial or residential sites and allocated land via sales or lease contracts to firms that conformed to specific criteria. Complemented by a policy which defined which kind of firms were regarded as 'important' for the local economy and therefore entitled to preferential access to land and lower tax rates add up to a policy where the city claims to control economic development. At the subordinate township level, government agencies practiced another policy, namely one of minimum interference. In this case, the allocation of industrial sites followed the highest expected returns in the form of taxes and income from land sales (or land lease). In other word, firms experienced an Arm's Length State at the township and a Developmental State at the city level. As the interviews further showed, in other townships the local administration acted like a Pre-Corporatist State in negotiating investment opportunities and establishing local firms under their control with certain individuals or groups, such as potential entrepreneurs or managers of TVEs and local branches of banks. The interviews also indicate that a change in economic regime is possible. For example, in one township the pre-corporatist orientation which was still prevalent in 2000 gave way gradually to a more market-oriented position during the privatisation process over the following years.

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Who Initiates Organisational and Institutional Innovation?

How to coordinate individual and firms' economic business behaviour is not completely determined by any of the three economic regimes described earlier. Instead private actors contribute to institution building directly when they invest in firms and decide on their corporate governance. They contribute indirectly to institution building when they conform to one business practice. The reason for doing so can be those of economic considerations when individual actors anticipate network effects due to positive externalities on the demand side. Another reason can be that these business practices are regarded as the 'normal' way of doing business – these routines are remembered forms from the pre-socialist past. The interviews confirm both assumptions: transaction cost considerations and the fact that cognitive and social legitimation are forces which influence the decision of entrepreneurs (Baron and Hannan, 2002) to embed firms in traditional social relations (Coleman, 1987; Granovetter, 1985; Greif, 1993). Again, transaction cost considerations and tradition point to the same direction of institutional innovation and change.

The need to cope with an insecure, quickly changing environment but also the lack of private savings or capital markets and the need to quickly acquire scarce market and political information make cooperation a profitable endeavour. Cooperation can take the form of an alliance with local government agencies. While a cooperation rent will be generated irrespective of which economic regimes had been chosen, the sharing parameter depends on the regime type with the Arms' Length State leaving the highest share in 'private' hands.

We will now turn to explaining the three forms of new coordination mechanisms which we identified with the help of the interviews – institutional competition, networks and corporate governance – in detail.

Local Institutional Competition

Oi's (1995) and Walder's (1995) path breaking studies on local state corporatization were the first of many field studies showing that local economic development depends on the governance of public–private relations within local jurisdictions and on the governance of intergovernmental hierarchical relations (see also Unger and Chan, 1995). Our interviews with entrepreneurs and government officials led us to further differentiate between horizontal and vertical intergovernmental relations. From an institutional perspective, our own findings as well as earlier research point to a governance structure that, from provincial to county and township level, enabled local governments to set specific local rules for their jurisdiction that were not hierarchically prescribed. These rules defined, for example, crucial procedures for privatisations, such as the minimum level of collective ownership, levels of private shares, or asset prices. Such forms of local autonomy are generally

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subsumed under the policy slogan of 'adapting (macro) policies to local conditions', but this slogan obscures the view of the major institutional consequence, namely that this set-up sanctions institutional competition between local governments. Pursuing this question in considerable detail, we found that such institutional competition aimed at increasing local investment could be found as horizontal competition across villages or across townships in a county. We also found vertically institutional competition between townships and counties, even across provincial borders, for example, by county-level governments devising investment incentives targeted at attracting investors from neighbouring provinces. Our interview partners clearly perceived this institutional competition as separate from other investment incentives, such as land prices or tax benefits, because of its long-term and structural effects. The scope for institutional competition has internal as well as external constraints.

Probing for the endogenous determinants of this local institution building, our interviews led us to also modify the established view that local governments or the 'collective' in the case of villages were the main force in defining new institutions. Although the notion of collective ownership in China bears some resemblance to the 'commons' or jointly owned resources (Ostrom, 1990), the dominance of property rights over land by villages or townships on one hand and over physical assets by businesses and entrepreneurs on the other suggests to conceptualise control over local resources as a constrained cooperation game between local governments and local businesses. Economic development and institution building depend on the interaction between these two groups. Both share an interest in economic growth of the local resource base, as each benefits from overall growth. Both groups have an incentive to cooperate. 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 local fees and taxation, land prices, direct resource control and other forms of intervention, while firms can secure a satisfying share by moving (or threatening to move) to another jurisdiction offering better institutions, 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' and from 'below' (employees or the local 'electorate', both being weak partners).

The exogenous constraints on local institution building are complex and depend among other factors on the functions of government agencies, their initial endowment, formal standing within the administrative hierarchy and government–Party interactions, details of which are part of a new and emerging research agenda.

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What matters in the context of institutional competition is the stability condition. Local autonomy in institution building will lead to a stable business environment when local groups are able to ensure the support of higher level governments for their institutional innovation. In other words, local dynamism in institution building exerts upwards pressure on higher level governments and, in extension, on the macro level to sanction successful institutional change from below.

The consequences of this interplay of internal and external constraints can only be shortly described. The upwards institutional pressure from below in turn puts constraints on the downwards hierarchical implementation of macro-level institutions, as each local level of government is put into a position of having to arbitrate between competing micro- and macro-level institutional demands. This obviously requires a flexible communication and decision-making structure, proof of which was found in the interplay of formal and informal institutions and in networking. Again, using Wujiang City as an example, we observed how township officials lobbied the county-level government to (informally) guarantee property rights (in land and resources) which had been granted to investors at township level. In turn, county-level officials depending on township authorities to reach their economic growth targets were not able to enforce their proclaimed industrial policies or specific forms of corporate ownership against the will of the lower level authorities. Subsequently, the county and the township negotiated non-interference at the lower level for (higher) transferred revenues. As the interviewees insisted, this process of mediation between authorities at different levels was not a controversial one, but rather of negotiation and mutual adjustment which happened largely in the public arena.

How much does institutional competition contribute to the emergence of different business systems? Undoubtedly, the devolution of power and revenue sources, such as the ability to define local privatization trajectories and to use proceeds from land management and the so-called extrabudgetary funds enabled local jurisdictions to design and finance specific institutional environments (Zhu and Krug, 2007). The next question is whether we can observe patterns of institutional designs which spread beyond individual local jurisdictions unleashing a process of 'convergence' to similar governance structures across local jurisdictions. Our interviews confirmed that institutional competition is a driving force which is openly acknowledged, for example, when local governments organise study tours to examine institutional practices in other jurisdictions. As capital and (skilled) labour will move to jurisdictions where the rate of return on investment (and human capital) is highest, the shared interest of managers, firms and local government agencies will force other jurisdictions to imitate 'good practices'.

There are also internal processes which drive localities toward a convergence of the institutional structures. As already shown by Marshall in the 1920s, positive externalities lead to the concentration of industries when (skilled) labour and

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intermediate goods are pooled and knowledge is shared. Thus, the building up of supply chains, firm-financed training and sharing of market-specific knowledge, but also the increased frequency of dealing with firms in the proximity, creates demand for wider institutional settings. The Pearl River Delta or the Lower Yangtze Delta are often quoted examples for regional convergence, but we found that from the local perspective, these refer to macro-level policies with only indirect impact on local institutions. Within these macro-regions, in this case the Lower Yangtze Delta, we found a marked variety of local institutional settings for which Marshall's insights equally hold, as businesses and local government at the micro level across townships and counties demand better 'harmonization' of policies and business procedures. At this level, the emergence of local business systems is more likely to be network driven, revealing shared business practices and 'habits', rather than political objectives or economic incentives.

Finally, the convergence of local institutions is influenced by national politics, when the central government or any other superior administrative level use the prerogative of national legislation and define national standards for certain sectors (e.g., over environmental protection). However, this does not amount to institutional centralisation. Hierarchical interference from the central government in the form of administrative interventions happens occasionally, for example in the case of the national tax bureaucracy or the local branches of the People's Bank of China. For institutional change, macro-level intervention is indirect and encourages local differentiation, for example by promoting 'models' for institutional change, such as the 'Wenzhou Model' or the 'Sunan Model'. According to our interviews, these models are completely obsolete as prescriptions for institutional change, but are regarded as important in so far as they sanction local institutional differentiation. The role of the macro level for local institution building lies more in the provision of an overarching institutional architecture which accommodates institutional competition that in turn is embedded in a governance structure which coordinates through checks and balances across the various levels of government.

The complex requirements for coordination between businesses, across the government–business divide and across levels of government, rely on networks, which themselves have their own institutional structures.

The three economic regimes relate in different ways to institutional competition. In the Arm's Length State there will be a trend towards institutional convergence beyond the local nexus, i.e., market-driven regional integration. The Developmental State, however, will define and redefine sectors and economic activities over which the government claims control either by a special bureaucracy or by asking lower level governments to act as implementing agencies for standardization. The Pre-Corporatist state, finally, will lead to the broadest range of institutional arrangements where innovation depends on negotiation within the local jurisdiction and between government agencies.

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The Institutional Role of Networks

To claim without further analysis that Chinese networks – based on *Guanxi*-(personal) relations – are unique and require a completely new social science approach has obfuscated the role of culture in business. Networking is indeed widely used in China, but that does not mean that it defies rational economic explanation. Our interviews and a fresh look at existing empirical studies (Gold et al., 2002; Wank, 1996; Yang, 1994) have prompted us to explain networking as a transaction cost saving device which admittedly incorporated, synthesizes and puts to new (global) use traditional features of Chinese culture.

Individual economic actors in transition economies face the alternatives of either acting alone, embarking on economic activities together with others, or asking government agencies to provide those goods and services which are too expensive or risky to organise privately (Coleman, 1987; Greif, 1993; Ostrom, 1990; Powell, 1990). Where markets do not function and government coordination does not work, private collaboration offers a high cooperation rent. This is not China specific, but part of the role of social capital in transformation processes in general (Grabher and Stark, 1997; Stark, 1996; Stark and Laszlo, 1998; for China see Boisot and Child, 1988, 1996; Xin and Pearce, 1996). The ubiquity and importance of networks in the business environment of China derives from the complex requirements for communication that arise within an institutional environment that relies much more on coordination and negotiation that on command.

Chinese social networks are formed by primary groups, such as the family, classmates, colleagues or friends where scale and scope of the networks is limited to a small pool of trusted people. In business, mutual trust and affinity in these networks help coordinate economic activities; and norms of reciprocity limit moral hazard and define sharing rules (Bian, 2001; Park and Luo, 2001; Redding, 1990; Wank, 1996; Yang, 1994, 2002).

Our own observations lead us to a modified view, in particular in regard to the boundaries and criteria for membership in business networks. On the surface, the local business networks we came across had open boundaries and low entry and exit costs; individual economic actors were generally members of several networks. The change from one network to another was neither seen as a breach of contract, a breach of loyalty, nor did it carry any negative sanctions. When a business relation no longer offered expected returns, it would be 'deactivated' but not terminated, in the sense that both partners would remain socially connected. These findings are still in line with traditional network structures. However, we found that parallel to this social or cultural rationale, there was an economic rationale at work which formed active business networks around economic assets as if by crystallization within the larger social network. In the broadest general terms, these active business networks consisted of members who were contributing to the exploitation of the asset, either by contributing management skills, finance, technologies and other business inputs, or, where required, property rights, infrastructure, approvals and similar government inputs. Membership of business networks is thus defined by the ability to contribute to the formation and exploitation of assets (Hendrischke, 2007) with no clear borderline between business and government members.

In the language of economic sociology such networks allow smooth switching from weak to strong ties (Granovetter, 1983). The contribution from our interviews is that networks accept and screen members for their ability to contribute to existing or future assets and that the strength of ties varies according to this ability. From an economic perspective, being involved in the joint exploitation of an asset indicates strong ties; being socially connected indicates weak ties. In theory, individual economic actors will embark on networking when they expect that networks offer a more effective means to coordinate resources and activities than either the market or the state bureaucracy. In China's institutional practice, and in view of the reliance of any economic activity on coordination between business and government, there is little alternative to networking. Networks contribute to the emergence of markets as prices and values of assets and business deals become less vulnerable to moral but, more importantly, to political and institutional hazard. This interpretation stands in contrast to the view that networking equals rent-seeking equals corruption which prevails in the analysis of other transition economies (Cheung, 1996; Shleifer and Vishny, 1993).

In a dynamic interpretation, two other features are important for explaining the diversity of networks and the limits to rent-seeking. Underperforming networks are not driven out of the market. Instead, they turn dormant (Kuilman and Li, 2006) and can be reactivated (at low costs) should relative prices and rates of return change. A diffused competition less steered by changes in prices (or marginal costs) than by changes in attention or interest on the demand side contribute to the activation process (Hannan and Carroll, 1992).

Demand for networks reflects the economic initial condition and the weak formal institutional architecture of the business environment rather than the more technical transaction costs which refer to firm size, sectors, or technology. Networks function as institutional entrepreneurs responding to new opportunities and changes in relative prices inherent to economic exchange relations. They are established to overcome the following:

1. Resource constraints (physical assets, human capital, lack of technology), by offering a governance structure for pooling resources (Krug and Polos, 2004; Peng, 2003);
2. Institutional weakness, in the form of ill-functioning markets, ill-defined property rights and the ambiguity of the reform course by offering local property rights protection, 'contractual' security and access to market information (Peng and Luo, 2000; Wank, 1996; Xin and Pearce, 1996);

3. The public goods problem; more precisely the lack of investment in physical and institutional infrastructure by investing in and operating public utilities and services. A related aspect is that networks offer forums where hard to exchange information, knowledge and experience can be jointly produced and shared, and thus the 'liability of newness' in the new private sector be mitigated;
4. 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, 2004; Oi, 1995; Walder, 1995).

It is worth noting that the need to fulfil these functions is not equally distributed across China. Rather, it is dependent on local economic and institutional conditions. For example, in the hinterland, resource constraints can be so dominant that networks will focus on this function. Likewise, in localities where an economic regime was chosen that fits the Pre-Corporatist model, networking for getting access to the political sector loses its value to the extent that networks are already officially part of the political process. The different functions constitute the diversity of networks that can be observed in China. Yet, networks are not exclusively locally embedded. They cut across local jurisdictions either by expanding along the technical transaction cost divide, by specializing on small firms, or sectoral clustering within different layers of government. The costs for doing so are lowest in the Pre-Corporatist State while the Arm's Length State will insist on market competition. The Developmental State acknowledges or fosters networks of technocratic elites in charge of economic development.

At the micro level, networks are closely involved in the formation and corporate governance of businesses as they provide the means for local government and local entrepreneurs to coordinate local organisational forms.

Corporate Governance as Form of Institutional Coordination

In a broad definition, corporate governance refers '. . . to a whole set of legal cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.' (Blair, 1995, p. 3). In China where private firms need to be established and empowered, corporate governance refers to the search for governance structures which are able to cope with political and market uncertainty while setting incentives for investment and commitment. This search process is reflected in the fact that economic development has been accompanied by a multitude of different types of firms.

Different localities in China still have firms with unspecified property rights where a community, in the case of TVEs, or local governments claim quasiownership. Yet most firms today are based on informal partnerships (as in the IT sector, see Greeven, 2007) or formal and registered (Krug, 2007). Subsequently, 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), to the effect that the incorporated sector contributed between 63 percent and 71 percent (collectives included) in 2003. Yet this does not imply a complete retreat of the state sector. Our studies (Krug and Hendrischke, 2003; Krug and Mehta, 2004) show that local government agencies during the privatisation process kept minority shares in most so-called private companies. They bargained for and obtained shares, as firms saw this as a way to limit government control of corporate cash flow. Managers and entrepreneurs used the transfer of shares to government agencies as a way to better 'align the interest' (Nee and Lian, 1994) and as an investment into social and political capital. To the extent that local governments profit from flourishing firms either directly (share on profit, tax revenue) or indirectly (investment, workplace generation, increase in land value) they have an incentive to cooperate by offering an attractive business and investment environment. The cooperation strategy leads to lower political and procedural hazards when local agencies protect the firms' assets and contractual relations. In short, incorporating firms not only hardens property rights, at the same time it also allocates risk to specified owners.

Property rights and risk consideration suggest an efficient 'loss management' for firms. Yet the spectacular success of Chinese firms can hardly be explained without the governance that allocates the innovation rent between firms and the share- or stakeholders. Innovation is less dominated by new technologies than by managerial skill, i.e., the talent and ability to change the organisational form of firms. While technical innovation is increasingly linked to the entrepreneurial rent in the private sector, 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. However, there is the extensive use of incentive (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) (Dong, Bowles, and Ho, 2002; Krug, 1997; Li and Rozelle, 2003). Most privatised TVEs (see overview in Li, 2005) relied on management buyouts where managers could convert their accumulated profits into shares. Crop-sharing contracts have been known in China for centuries (Cheung, 1969) and provide another example of tradition as well as transaction cost considerations informing institutional choice.

Our interviews show that in the local context, managers, government agencies and stakeholders negotiated appropriate forms of corporate governance. This happened parallel to the expansion of formal private property rights and the general conversion of businesses to limited liability firms. The question of convergence of different local forms of corporate governance is therefore not answered by pointing to the increasing prevalence of limited liability firms, but by the continued formal and informal participation of local governments in corporate governance of local businesses and by the spatial or a jurisdictional (i.e., economic regime) dimension of this government participation.

The local perspective as constructed from the interviews points to three factors which play a role for the convergence of local business systems. The expansion of markets will lead to more choice in how to coordinate inter-firm activities at declining transaction costs. Thus, localities where (more) markets function better will see a higher concentration of organisational forms that reflect pure economic considerations. In contrast, inherited industrial structures limit organizational choices as former SOEs are subject to state intervention via 'shares' or regulation. The effect is, as the firms in the interviews complained, that localities where large (former) SOEs constitute a considerable part of the industrial structure see less organisational and institutional innovation at the local levels – there is not much to be gained for local government agencies and firms from cooperating. A last factor which contributes to a clustering of organisational forms is the economic regime chosen. While Arm's Length States will interfere only in case free choice leads to monopolies or cartels, the Developmental State will limit privatisation and organisational forms according to politically defined development plans. In the Pre-Corporatist State, finally, the organisational form will remain weak and depending on negotiation among stake- and not shareholders.

DISCUSSION

The results point to two major agents of institutional change, namely businesses (entrepreneurs and managers) and local government agencies whose interaction resulted in three institutions which appear irrespective of the kind of economic regime chosen and therefore can be regarded as constituting factors of the overall (national) business system: local institutional competition, i.e., collaboration of economic and political actors; business to business and business to government networking; and corporate governance across the government business divide. At first sight these results seem to be hard to reconcile with some mainstream findings from New Institutional Economics or organisation theory.

1. Decentralisation of decision-making power to micro-level agents triggered off a form of entrepreneurship which did not limit itself to recombining productive forces (Grabher and Stark, 1997). Instead, the business sector and local government agencies changed institutions in the local business environment through coordination and negotiation. Incentive contracts with managers and alliances with local government agencies led to the emergence of firms

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which were rewarded by more secure property rights if they performed well. This is in striking contrast to conventional (e.g., North) models which assume that a central authority, i.e., the government or the constitution guarantees property rights protection irrespective of the performance of assets or the use of resources (Krug and Hendrischke, unpublished data, 2007). We argue that property rights in the Chinese local set-up are a reward for good performance. It also draws attention to the missing link in co-evolutionary theory which concentrates on niche driven co-evolutionary processes of firms and industries (McKelvey, 1997) and fundamental co-evolutionary change where political factors cannot be dismissed.

2. The interplay between local competition and coordination is the crucial element in institution building and organisational choice. Terms such as adaptation or selection are too broad for identifying the crucial elements in institutional change. Adaptation in China refers to collaboration between actors at the micro level in the form of contracting, participation in rule-setting agencies, networking or alliances. Institutional competition is comparable to yardstick competition (Belleflamme and Hindriks, 2005; the classic is Besley and Case, 1995), where economic actors compare different jurisdictions (localities). Overall (macro-) institutional change follows complementarities, i.e., synergy effects which occur when increasing investment into one activity at the micro level increases the returns form another activity, i.e., market coordinated activity. As was shown above, corporate governance, networking and institutional competition contributed to the expansions of private business activity and the expansion of markets.
3. Organisational choice in China supports the resource-based view of the firm, more precisely the dynamic capability approach (Teece and Pisano, 1994, see also Lewin et al., 1999; Tsang, 1998) with the modification that social capital, i.e., the ability to influence the institutional environment is seen as a crucial capability.

CONCLUSION

All in all, the co-evolutionary perspective offers a conceptual frame that can be fruitfully exploited for analysing 'fundamental change' (Nelson and Winter, 1994). By taking the micro (local) level as a unit of analysis, the incremental endogenous change that underpins the changes at the macro level is identified. By including political factors at the macro and micro level, 'links' such as strategic games, bargaining and alliances can be identified which go beyond the Western parochial view which assumes that democratic representation is the only institution by which a businesses can convert demand for institutions into a corresponding supply. In other words, our results add to the more recent literature which asks convergence of approaches from organisation theory and New Institutional Economics (Lawrence et al., 2002; Peng, 2003).

Finally, our analysis points to changes in methodology. While growth theory and the transition literature rely on a macro-level perspective and quantitative data focusing on institutional change over long periods of time, our study contributes to a micro-level and process oriented analysis of change. The interviews at the local level offer a valuable source for identifying new agents of institutional change, their motivation (and incentives), the effective (formal and informal) constraints in the business environment and their response in form of investing in dynamic capabilities.

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Barbara Krug (bkrug@rsm.nl) is Professor at the Rotterdam School of Management and University of Manchester. Her principal research interests include economics of governance, New Institutional Economics, and endogenous institutional change. Her recent publications include *The Chinese Economy in the 21st Century*, Cheltenham: Edward Elgar (together with Hans Hendrischke).

Hans Hendrischke (h.hendrischke@unsw.edu.au) is Associate Professor in Chinese Studies, Faculty of Arts and Social Sciences at the University of New South Wales, Sydney. His research interests are in Chinese provincial studies, in particular local economic institutions. His latest publication is *The Chinese Economy in the 21st Century*, Cheltenham: Edward Elgar (together with Barbara Krug).

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