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Entrepreneurship by Alliance

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ENTREPRENEURSHIP BY ALLIANCE

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**ABSTRACT**

This paper draws on transaction cost theory and institutional economics to analyse modes of entrepreneurship in the newly reformed China. The account which is developed is supported by fieldwork in China. We claim that four idiosyncratic features of the business environment (the emerging market situation, the dual economy, weak institutional arrangements, and the 'newness' of private enterprise) generate a particularly high level of economic and institutional uncertainty for would-be entrepreneurs. The high transaction costs associated with uncertainty, together with resource constraints, push entrepreneurs into the alliances with others that are essential for success in contemporary China. We analyse the tasks performed by alliances and conclude that our account of entrepreneurship points to the significance of factors which lie beyond the neoclassical theory of the firm.
1.0 INTRODUCTION

The success of China's economic reforms would appear to be directly attributable to the success of its entrepreneurs. The number of firms outside the state-planned sector has grown rapidly in the last twenty years. It is these firms – and not state enterprises – who increasingly supply Chinese consumers with the goods they need and want. And it is these firms that have become the engine for growth in the economy through their search for new production techniques and through the creation of new forms of employment outside the agricultural sector. Today, the central state finds it hard to ignore its new manufacturing and service sectors, not least because it is these sectors which, in the last eight years, have been generating forty per cent of state revenue and forty per cent of export earnings per annum (Qian, 2000).

Such a development raises interesting questions for those concerned with economies in transition – in particular, how do new firms come into being and what factors are crucial to their success? After all, private enterprise is a novel phenomenon in the People's Republic of China and very few individuals are familiar with market economics. In this paper we point to idiosyncratic features of the environment in China in which entrepreneurship takes place. Drawing on elements of transaction cost theory and institutional economics, we show how these features influence the practice of entrepreneurship. We claim that the successful establishment of a new firm and its expansion path turn on the ability of the entrepreneur to gain access to pools of tangible and intangible resources. Thus, the successful entrepreneur is one who can identify, and form alliances with, individuals and groups of individuals with access to the resources essential to production.

Our account is supported by 27 case studies of entrepreneurs acquired through fieldwork in China in 1999. The age and activities of respondents are described in Table 1 (in the Appendices). Fieldwork took place over a period of five weeks in Shanxi Province. This area was selected because it has an extremely fast-growing private sector but has not been a major recipient of foreign direct investment or preferential treatment by the State. Growth has therefore been endogenous. Interviews were semi-structured and lasted for at least two hours (and sometimes much longer) with the aim of capturing qualitative data. It cannot be claimed that the sample of respondents is representative by the usual social-scientific standards of Western research practice, since we were dependent for access to entrepreneurs on one of the principal commercial banks of the region, a university in the provincial capital, and local Party officials, all of whom may have applied their own filters to the sample. The alternative would have been to wait however long it takes for Western sampling methods to be acceptable and practicable. Nonetheless, we suggest the resulting dataset is rich in information and offers a unique glimpse of key features of entrepreneurship in Shanxi Province at this stage of the reform programme.

The paper is organized as follows. Section 2 establishes the context in which entrepreneurship takes place; it describes the high level, and particular features, of uncertainty which characterizes the economic, social and political environment in China and which generates high transaction costs for would-be entrepreneurs.
Section 3 describes two crucial relationships — between uncertainty and profit, and between uncertainty and production — and their implications for the practice of entrepreneurship. Section 4 develops the claim that high transaction costs, together with resource constraints, push entrepreneurs into the alliances with others that are so essential to success in the Chinese business environment. Section 5 concludes with a discussion of some of the ramifications of our findings. And then the Appendices contain short case studies of three representative entrepreneurs.

2.0 CONTEXTUAL CONSTRAINTS ON ENTREPRENEURSHIP.

The economic, social and political environment facing any potential entrepreneur in the newly reformed China has distinct transaction cost-generating features. These features need to be regarded as inter-relateds but for expositional purposes they can be described under the following four headings.

2.1 The emerging market situation

The emerging (or nascent) market situation in China is characterized at best by poorly functioning markets, and at worst by missing markets, for capital funds, risk management and information (Stigler, 1989). In addition, factor and final goods markets are highly segmented. This situation necessarily adds to the costs of undertaking transactions. But given the newly unleashed desire for consumption in China, it also means that individuals can earn high profits if they are able to identify ways of pooling resources and of establishing business relations across markets and provinces. Thus, budding entrepreneurs face both high deterrents to market entry and robust incentives to succeed.

2.2 The dual economy

At this stage of the reform programme, China is characterized by the co-existence of a socialist sector where economic activity continues to be coordinated by centrally-planned quotas and low state-controlled prices, and a competitive, free-enterprise sector where activity is coordinated by the price mechanism with (relatively) free entry to private entrepreneurs. Producers would face far less uncertainty if just one sector predominated, and if that sector manifested some stability. As it is, both the socialist sector and the free-enterprise sector are in a state of flux. Negotiating the divide between sectors is a primary source of transaction costs; for example, obtaining information about demand and supply conditions, and then acquiring access to buyers and suppliers, are processes which bear high positive costs. But success has high rewards: an individual who succeeds in buying inputs at low state prices while selling on their final or intermediate goods in competitive markets can appropriate the profits accruing to arbitrage (Nee & Matthews, 1996; Nee & Su, 1990; Nee, 2000).

2.3 Weak institutional arrangements

The weakness of the inherited institutional environment is manifest in four key areas (Whitley, et al., 1996).
First, there is chaos and confusion in the assignment of property rights leading to difficulties in obtaining the land needed for production and then uncertainty and insecurity of tenure. Weak property rights have implications for the practice of entrepreneurship: risk has to be spread, and good relations need to be maintained with those politicians or bureaucrats who maintain control over property rights (Puttenman, 1995). A brief history of recent reforms demonstrates the point.

In the period 1980-84, attempts were made by the central State to establish ownership or possession of assets as a means to supporting private enterprise activity (Krug, 1997a). The State now ‘guarantees’ that asset holders can exclude others from use of the same asset. This guarantee does not constitute a complete property right in the Western legal sense but is a ‘possessory’ right (Furubotn & Pejovich, 1974; Posner, 1980; Fukuyama, 1995) which is legally binding only when resources are used within the politically defined market sector and where effective law enforcement agencies exist. The new legislation has had consequences for the state manufacturing sector located primarily (but not exclusively) in urban areas, and for the countryside. In the case of the former, special state agencies find they can become the ‘lawful’ owners of physical and financial assets. And in the case of the latter, the village has been established as the ‘natural owner’ of all assets within village boundaries, with the further assignment of property rights to individuals contingent on negotiations within the village, or its next superior administrative unit (such as the county) (Rozelle & Li, 1998). Under these conditions, two procedures have come to dominate the transfer of assets to groups and individuals outside the state sector. First, control over resources and possession is commonly recognized as the first step towards the acquisition of property rights. This procedure can be thought of as one of ‘cold privatisation’; it is the means by which state cadres previously in control of resources are able to transform themselves into the managers, if not the owners, of those resources. The second procedure is to acknowledge past investment into a resource. Thus, land which hitherto was farmed by a group of households under the People’s Commune System is apportioned and assigned to private households within that original group. However, at the most, this second procedure secures sharecropping and similar lease contracts while full, legally-enforceable private property rights are still missing. The net result of these reforms is that bureaucrats, Party cadres, and other local politicians continue as a force to be reckoned with in determining who can do what with land which is in private hands.

Second, the growth of private enterprise activity has led to the evolution of a variety of agencies who seek to act as ‘go-betweens’ or intermediaries in the negotiations between actual and potential business partners (Nooteboom, 1999). The demand for intermediaries is high; as one of our respondents pointed out, China has an inadequate capital base and intermediaries are needed to locate sources of capital and to broker agreements. The new agencies include law and accountancy firms, commercial banks, chambers of commerce, and trade associations. They resemble their counterparts in the West in terms of their structure and organization, and the services they appear to offer. Through their activities a range of quasi-institutional business arrangements has been engendered, such as ‘laws’ and ‘legal’ precedents, accountancy procedures, capital markets, and guidelines for business practice.
The new agencies would appear to contribute to a reduction of the transaction costs associated with the management of risk, the acquisition of capital funds, the enforcement of contracts, and the dissemination of information. However, they are inadequate to the task of lubricating the wheels of private enterprise. Since the arrangements they engender do not emanate from the State which, still holds a central position, their status is undetermined and at best equivocal, particularly where transactors seek to cross provincial boundaries, which is increasingly the case. And since the experience of agency personnel is limited, and the coverage of exchange relations is incomplete, the capacity of the new agencies to broker and subsequently to enforce the wide range of novel transactions is commonly recognized by entrepreneurs to lack substance. For example, all of the 27 entrepreneurs whom we interviewed spoke of the inadequacy of the services provided by commercial banks, and/or described access to capital, appropriately skilled labour, and information as key problem areas.

Third, the reform process in China has been characterized by on-going shifts in the regulatory regime. While regulations are negotiated and agreed in the first instance at the centre in Beijing, China is de facto a decentralized (that is, federalist) state in that each locality enjoys the leeway to modify – and even create – its own regulatory regime. As a consequence, entrepreneurs do not face a unified system of taxes, laws and regulations but a variety of systems which differ from province to provinces and sometimes even from county to county within a single province. The overall mix of taxes, laws and regulations is, then, experienced as a ‘soft’ and eminently malleable constraint on economic activity; in particular, the tax base, the tax rate, and the application of regulations are all open to negotiation – at least, to those with influence.

Finally, despite encouragement of private enterprise from the State centrally, and despite some advances in the assignment of property rights, economic activity continues to take place under considerable risk of confiscation as a result of opportunism and/or where private enterprise is frowned upon by the local political leadership. In the early days of the reform programme, confiscation involved the seizure of physical assets or bank accounts from private firms or households; nowadays, it can take the equally unpredictable form of ad hoc taxation once net profits are known, and can involve the sudden appearance of party cadres on the doorstep asking for a share of the returns (Krug, 1997b; Gambetta, 1993). Respondents provided enough anecdotal evidence to suggest that ad hoc systems of taxation, or ‘invitations’ to contribute to local community facilities (such as schools and temples), are a real threat which entrepreneurs take into account.

The very real risk of confiscation of assets, together with the malleability of the regulatory regime, has implications not only for the conduct and performance of private enterprise once it is up and running, but at the planning stage when the decision is taken about whether or not to proceed with a business venture. Arguably one of the most dramatic differences between the business environments to be found in China and in the mature economies of the West is that the expected returns to an investment or productive activity cannot be calculated solely by reference to economic parameters: the political climate has to be taken into account. As one respondent remarked, “Everything depends on the government”. Even if the current
political constraints on economic activity are common knowledge, the potential exists for subsequent changes to be negotiated in political markets and for these to have an impact on economic performance. This kind of uncertainty can be mitigated by maintaining good relations with representatives of local government. For example, one respondent said his firm was completely immune from political events because “I have influence” with Party officials.

2.4 The ‘newness’ of private enterprise

Private enterprise is novel in China and exists in a cultural vacuum, and so the very newness of the private firm as an organizational form generates a high level of uncertainty for would-be entrepreneurs (Krug & Polos, 2000). Several factors contribute to this kind of uncertainty. First, budding entrepreneurs are endowed with a low level of expertise with regard to the organization and management of private firms. However enthusiastic the current generation is to embrace private enterprise, the formal education they received did not supply them with the expertise and acumen necessary for sound business practice in a market environment. Nor is there a general knowledge about the mechanics of demand and supply, and price- and income elasticities, or a systematic knowledge base which would help entrepreneurs to identify and subsequently to quantify the risks associated with their ventures. Second, there is no obvious model on hand to imitate and no recognized procedure to appropriate, and nor can expertise be bought. Third, in the absence of a history of experience of business strategy, there is no collective memory about what can go wrong and how to resolve problems when they arise. And finally, there are no accepted routines of business practice which economic agents can rely on.

Given growing domestic demand for final and intermediate goods, a low level of competition from indigenous suppliers in most markets, and (as yet) poor penetration of markets by foreign firms, Chinese entrepreneurs have robust incentives to succeed. Yet the four features of the economy we have described in this section (the emerging market, the dual economy, weak institutional arrangements, and the newness of private enterprise) all point to a high level of institutional uncertainty. We use this term in order to emphasize two facets of the environment which potentially constrain entrepreneurial activity in contemporary China: (i) weak institutions are unable to reduce uncertainty in the business environment, a task which strong and established institutions perform in a mature economy; and (ii) the very co-existence of a multiplicity of different institutional forms and practices is a source of uncertainty itself. Under these conditions, the transaction costs accompanying production and exchange relations are high, and mistakes are expensive. In particular, customer and supplier firms, employees, investors and other business partners cannot be expected to act according to well-established and, hence, predictable patterns of behaviour, as they might in a more mature and stable environment. The rational entrepreneur can expect instead to elicit a large variance in the responses of economic agents to his or her actions, and a large variance in the responses of business partners to external shocks (Stinchcombe, 1965). Moreover, while the potential exists for costly principal-agent problems (specifically, the problems of adverse selection and moral hazard), it is not within an entrepreneur’s power to enforce a specific kind of behaviour since social and legal mechanisms of enforcement are unstable, can change
rapidly over time, and are likely to vary from one locality to another. In the next section, we develop the implications for the practice of entrepreneurship posed by high levels of economic and institutional uncertainty.

3.0 UNCERTAINTY, PROFIT, AND PRODUCTION.

Entrepreneurs in China are keen to ensure that their firms become sufficiently well-established to generate a steady flow of income. This objective translates into the pursuit of long-term relations in factor and product markets in order to minimize the risks of opportunism and to transcend the mere wheeling and dealing of spot markets\(^4\) (Williamson, 1985 and 1993). In these respects, the practice of entrepreneurship in China bears similarities with its practice in the mature economies of Japan and the West (Sako, 1992; Lyons & Mehta, 1997). But as we have already observed, it is particularly difficult in China to assess the level of risk associated with a business venture: is this the right product of the right quality?; will the market prove to be profitable? how should costs and revenues be calculated? can business partners be relied upon to abstain from opportunism?; will local government approve of the enterprise, or frustrate it?; how secure are profits and assets? Economic and institutional uncertainties have implications for the behaviour of entrepreneurs.

3.1 The Relationship between uncertainty and profit

As a starting point, we may say that entrepreneurs want to improve their position by engaging in productive activity – but uncertainty defines the subset of entrepreneurs who actually proceed to the production stage. High uncertainty in the business environment means it would be rational for potential entrepreneurs to expect a large variance in the profits from their business ventures. This conclusion will eliminate all but those who are the most adventurous, imaginative and risk-loving. It follows that any action on the part of the potential entrepreneur which results in less uncertainty will increase the expected net returns to a venture and lower the boundary on entrepreneurship. In other words, the set of actual entrepreneurs will include those who are most able to reduce the level of institutional uncertainty.

Success in production confers a positive externality on the wider population of potential entrepreneurs in an evolutionary fashion (Nelson, 1996 and 1997). Ceteris paribus, the larger the number of private firms which become established in an emergent market, the better that market functions for all its actual and potential participants, both on the supply side and the demand side. Once again, the boundary on entrepreneurship is lowered. Not only do prices and profits begin to act as reliable signals, but successful entrepreneurship adds to the knowledge base of the economy and offers new models of behaviour to be imitated. Success also exposes new opportunities to supply which, if exploited, generate efficiency gains and raise profit margins: the market reaches a point of development where for certain inputs it becomes efficient to switch from the internal hierarchy of the firm to new sources of supply. In other words, as factor and final goods markets become established through successful entrepreneurship, it may be expected that the gains to specialization associated with an increasing division of labour can be realized. Given the early stage of the reform process, it will be some time before markets are so competitive that
profit margins start to be squeezed. Thus, success in entrepreneurship simply adds to the opportunity set faced by the population of would-be entrepreneurs (Nelson, 1996).

### 3.2 The relationship between uncertainty and product focus

In a situation of emergent markets and where there are political as well as economic uncertainties, two special risks attach to the concentration of activity on a single product that call for special kinds of insurance. First, through a combination of poor information, miscalculation, and insufficient expertise, entrepreneurs may find themselves operating at the margin where they are at risk of being driven out of the market, for example, where start-up costs have been underestimated, revenues are less than expected, or the wrong product has been produced. Second, unanticipated changes in the political climate or to the legislative framework can quickly change business conditions for the worse in a particular market or locality; for example, entrepreneurs may suddenly find their personal and corporate assets at risk of confiscation or actually confiscated. Under these conditions, it becomes rational to consider not only current but future options on business activity by creating and maintaining a portfolio of ‘real options’, that is, a wide-ranging set of production possibilities such that resources can be diverted to additional or alternative activities at minimum cost and at the optimal moment (Jin, 1996; Trigeorgis, 1993).

The attention given by entrepreneurs to current and future production possibilities is exemplified by the perplexity of respondents when asked to specify their core business activity. The notion of ‘core competence’ turned out to be wholly irrelevant to respondents in deciding which activities to engage in. For the most part, a firm is not known by what it produces but by who stands behind the firm, and that individual will seize on any profitable opportunity which presents itself, without regard to any core competence the firm may, or may not, have. Fieldwork revealed expansion was characterized either by an increase in the scale of production within or beyond provincial boundaries (21 cases) or by diversification into a wholly unrelated sector (6 cases). To exemplify the latter, Case Number 16 began his career in the private sector selling colour television sets and has subsequently moved into car and motorcycle sales, real estate, brick production, and the recreational services sector; and Case Number 17 began in the coal and iron industry and has expanded into biological engineering and the supply of biological products.

These observations have implications for the way in which the firm is modelled. The neoclassical model of the firm, characterized by a single product and a single production function, is inappropriate since it presupposes that it is economic parameters alone which determine the core activity, the level of product diversity, and the extent of vertical integration or investment in other locations. This model has been criticized by institutional economics, and by managerial and behavioural theories of the firm, for its treatment of the firm as a ‘black box’, and its neglect of personal identities and the broader architecture of the business environment which are crucial factors in the Chinese context (Bradach & Eccles, 1989; Furubotn & Pejovich, 1974; Granovetter, 1985; Pratten, 1997; Williamson, 1993). In China, a rational entrepreneur will invest in forms of capital which enhance the ability to move rapidly from one sector to another, or from one locality to another, without the loss of large sunk costs. Thus, unlike the modern Western-style firm which tends to concentrate
investment on firm-specific or product-specific know-how, Chinese entrepreneurs concentrate their investment on transferable assets. The single most transferable asset which the entrepreneur has is him/herself and their social capital in the form of the ability to mobilize allegiances. The assets which are embedded in the person of the entrepreneur are secure from confiscations which means they can easily be transferred into alternative income-generating activities and from one locality to another. This facet of successful entrepreneurship could also explain why most of the individuals we encountered were endowed with wide-ranging personal attributes or endowments, such as charm, charisma, and persuasiveness, as well as intelligence, adaptability and imagination, all of which are important to success in the Chinese context. But the theoretical framework provided by neoclassical economics is ill-equipped to model such factors.

In the next section, we show that these two effects of uncertainty, together with a scarcity of resources, have powerful implications for the conduct of entrepreneurship in the Chinese context: in particular, entrepreneurs are pushed into alliances with others. It is the ability of the entrepreneur to form alliances, and the subsequent rents from cooperation, that are crucial to the establishment and on-going profitability of firms. Thus, success in entrepreneurship calls for more than a bright idea, a good product, or the willingness to accept risk. Without heavy investment in the kind of alliances which minimize transaction costs, the future of the firm will always be in serious jeopardy.

4.0 ALLIANCES.

It was not until 1994 that banks would give loans to private entrepreneurs and even now capital markets are poorly developed and supported by an inadequate capital base. Yet obtaining access to capital, while clearly important, is not the crucial element in successful entrepreneurship. Potential entrepreneurs begin their career in the private sector with a small personal endowment, the single most valuable component of which is the social capital embodied in themselves. This is because the key to success in entrepreneurship is the pooling of resources. At this stage of the reform process in which information is disaggregated, contractual security is weak, and the assignment of property rights is incomplete; the ability to gain access to resources translates into the ability of the entrepreneur to locate, and then to affiliate themselves with, the ‘right’ kind of other economic agents. In other words, the pooling of resources takes the form of a group formation, or alliance, with economic agents amongst whom there exists the potential to reap mutual benefits. Under these conditions, the Western concept of ‘entrepreneurship’, with its focus on the ability of the individual to identify profitable opportunities, needs supplementing (Kirzner, 1973 and 1985). In China, the key factor in successful entrepreneurship is the ability to form an alliance with those economic agents who possess or control the financial assets, physical assets, or specific human capital needed for brokering market entry, that is, for starting production, securing supply, and gaining access to distribution channels (Cheng & Rosett, 1991; Nee, 1989). These alliances render immediate value to the budding entrepreneur, not only by making production possible in the first instance, but by reducing the level of risk and increasing the expected net returns to a venture.
First, the difficulties associated with the dual economy can be overcome by the entrepreneur if entry to the erstwhile socialist sector can be secured. This translates into the need to form an alliance with those politicians or bureaucrats who control entry to the socialist sector. Entry can then be secured through a series of bribes or a share of the profits to a venture, or some other mutually beneficial exchange. Here, numbers matter: the greater the number of private entrepreneurs who penetrate the socialist sector, the sooner effective competition will start, and the sooner a fully functioning price mechanism will replace the hierarchy of the unified state plan.

Second, the difficulties associated with weak institutional arrangements can be overcome by forming an alliance with those able to promote and sustain a stable business environment. This can be understood as a novel form of private collective action which we suggest is an idiosyncratic feature of Chinese entrepreneurship. An effective alliance has four transaction cost-saving properties in this respect:

(i) It provides access to insider information which allows the entrepreneur to anticipate changes in the regulatory framework, and to acquire information relating to markets and to the factors of production.

(ii) By generating its own influential codes of behaviour, the effective alliance is able to reinforce the inadequate legal system with social and political sanction thereby providing a higher level of contractual security than would otherwise be available.

(iii) The effective alliance provides room for experimentation in two ways: it ensures that an entrepreneur can fail once but return for a second attempt, and it forms a buffer against failure in the first instance.

(iv) The effective alliance acts as a form of collective memory, ensuring that a single failure need not be constituted simply as one individual’s loss of investment but as an experience which others can learn from, that is, as a positive externality. In this way, sequential entry in a new business environment positively adds to the knowledge base.

Numbers count in the performance of these transaction cost-saving tasks: the greater the number of economic agents who participate in the alliance, the more effective it will be in the dissemination of information, the management of risk, and the monitoring and sanctioning of business practice which, as a consequence, lowers the costs to the individual entrepreneur. With these significant benefits at stake, the fortunes of entrepreneurs are heavily dependent on their ability to form alliances with bureaucrats, political leaders and other significant parties in the business environment.

Third and finally, the ability to form the ‘right’ kind of alliances can mitigate the transaction costs associated with the newness of private enterprise. The problems associated with newness include not only missing institutions, such as the banking services or tort laws which support private sector exchanges, but also missing business practices, such as the norms, conventions and routines which determine ‘how
things are done'. These practices constitute a form of tacit knowledge which is present in the mature economy but missing in the newly reformed China. The effective alliance performs a crucial role in the development of tacit knowledge by creating and promoting a stable set of expectations of 'good' business behaviour. Once again, numbers matter: the greater the number of economic agents who have internalized the same practices of behaviour, the more smoothly and efficiently can business be transacted and the lower the monitoring costs. Conversely, the more heterogeneous the business environment is (that is, the more different practices that co-exist), the higher the transaction costs because each new exchange relation must be negotiated afresh to avoid misunderstandings and ambiguities. Entrepreneurs in China are aware of heterogeneities in their business environment: as several of our respondents indicated, they expect people from other regions to behave differently, even to speak in dialects they cannot understand. And they are sensitive to the need to create mechanisms to deal with difference, chief of which is the alliance of like-minded individuals who see the value of establishing common practices.

5. DISCUSSION AND CONCLUSION.

We have suggested that entrepreneurial success in China turns crucially on a system of alliances. This system can be understood as a means of creating and mobilizing the economic, social and political capital required to lubricate the wheels of private enterprise in an environment characterised by a high level of institutional uncertainty. Within this system, the identities and personal attributes of individuals are key elements, which would explain why we observe a large number of Chinese firms with weak organizational identities combined with the high exposure and strong personal charisma of the owner. The right kind of alliances help to overcome resource constraints and to minimize transaction costs through the pooling of both tangible and intangible assets, the spreading of risk, the monitoring and enforcement of business deals, and the creation of a stable business environment. Alliances are also valuable because they offer patronage and trust-generating mechanisms, and because they reduce search costs. Thus, alliances function as a repository of knowledge about business opportunities and the location of human resources (particularly with respect to skilled and/or scarce labour). This account of entrepreneurship is distinctive in that it raises the profile of the processes which take place in order to establish a firm in the first instance and downplays the significance of the production function in the subsequent behaviour of the firm. In contrast, an account which only begins with a production function is inadequate for explaining the conduct and performance of the firm in the Chinese context.

Our account is supported by fieldwork which reveals that entrepreneurs are discriminating in their choice of who to form an alliance with and seek out those who offer the highest expected returns. It follows that the expansion path of firms is driven by differential access to alliances; for example, if an entrepreneur has access to alliances which can broker influence in the state sector, he or she are likely to move into productive activities where bureaucratic controls are greatest. In other words, the forms taken by social capital are a driving force in the development of the private sector.
Fieldwork also reveals, in contrast to claims in the literature (Redding, 1996; Fukuyama, 1995), that the family does not play a major and on-going role in the firm. In those cases where a member of the family had given a loan, it was repaid as rapidly as possible, and we came across no instances of a loan being accompanied by legal entitlement to a share in either the risks or the profits associated with the venture. Moreover, a loan did not grant authority in decision-making. These features indicate that neither party regards the loan as an ‘investment’ and, hence, that the family cannot be regarded as a capital-pooling institution.

Given the role of alliances, why is it that entrepreneurship in China has not become prone to the business practices to be found in the countries of the old Soviet Union and, in particular, of Russia, where a single alliance – the Mafia – predominates? Our fieldwork to date has been restricted to one province only and so we can only speculate as to the answer. But we would suggest that entrepreneurship in China is distinctive in that the mutual gains to cooperation are highest in the presence of a multiplicity of alliances and when there is an element of competition between them. Fieldwork suggests that no single alliance has the monopoly on all business transactions and that competition between alliances takes the form of ‘product differentiation’. For example, members of the army specialize in their ability to locate certain kinds of qualified labour and thus provide a pool for engineering and mining skills and expertise with chemicals. We also came across evidence of the part played by alumni clubs in providing access to distribution channels; for example, networks of old classmates were used as reliable contacts by two respondents wanting to market products in distant provinces. Entrepreneurs, for their part, face strong incentives to gain entry to more than one alliance and to be discriminating; they seek out the combination of alliances which promises the highest returns on membership, rejecting those they have no use for. Of course, it remains to be seen if this system will survive further stages in China’s transition process.

In venturing these claims, we do not suggest that cultural difference is the single most important factor in explaining the forms taken by entrepreneurship. We would argue instead that it is the nature, level and source of uncertainty which determines the particular way in which private markets emerge; in the case of China, the high level of institutional uncertainty is a crucial factor. Clearly, further comparative work elsewhere in China is needed in order to develop this thesis. But, certainly, our fieldwork so far points to flaws in the neoclassical framework which takes the already-existing firm as the unit of analysis and begins its story there. We suggest that a deeper understanding of entrepreneurship in China is acquired by treating the firm and its expansion path as an evolutionary process in which the conditions for success and failure are laid down well before an actual firm comes into being.

FOOTNOTES

1. A copy of the interview schedule is available from the authors on request.

2. The seriousness of these problems was openly acknowledged by the senior representative of one of the largest banks in the province who introduced us to many of our respondents.

3. This respondent (case number 20) describes himself as ‘The boiler king’ and was introduced to us as a ‘model entrepreneur’ by two senior members of the local Party who accompanied us to the interview.
By coincidence, he had been interviewed by one of the authors two years previously when he was in the process of being made bankrupt after an investment in supermarkets had failed. This information was clearly known by the Party cadres but only reluctantly acknowledged. Given his effusive declarations of Party loyalty, one may speculate that the ease with which he has re-established himself in the private sector is due largely to his political connections.

4. While the ‘wheeling and dealing’ which takes place in spot markets constitutes a form of private enterprise, it may be regarded as conceptually distinct from the more enduring forms of business activity which characterize entrepreneurship and which involve the establishment of a firm and capital accumulation.

5. The profit margins of several of our entrepreneurs were protected either by their strong position as first entrants and/or their total monopoly of the market. When asked whether the entry of new competitors would place the firm in jeopardy, 16 (59%) respondents answered positively, but only two respondents were actually facing new competition, and one further respondent said he would actually welcome new competition because of the benefits in terms of new technology and ideas. But more importantly, new entry is universally seen as less of an issue than government policy and local Party attitudes with respect to private enterprise. For example, one entrepreneur felt that his firm controlled the market as a direct result of local government protection. Another respondent said that the entry of foreign-owned enterprise into his market (biological engineering products) was being made difficult as a result of a policy of import-substitution; since this policy was being supported by the Academy of Sciences, the crucial factor in this firm’s success was perceived to be their good relations with the Academy.

6. One respondent went so far as to draw our attention to the distinction he made himself between ‘financial and social capital’.

**BIBLIOGRAPHY**


# APPENDICES

## TABLE 1: Age and Principal Private Sector Activities of Respondents

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<tr>
<th>CASE NO.</th>
<th>AGE</th>
<th>PRINCIPAL PRIVATE SECTOR ACTIVITIES</th>
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</thead>
<tbody>
<tr>
<td>01</td>
<td>36</td>
<td>wholesale supply of electrical appliances for bakeries, retail sale of electrical appliances and furniture</td>
</tr>
<tr>
<td>02</td>
<td>33</td>
<td>wholesale and retail supply of cars and low-quality pick-up trucks</td>
</tr>
<tr>
<td>03</td>
<td>35</td>
<td>retail supply of high-quality cars</td>
</tr>
<tr>
<td>04</td>
<td>38</td>
<td>wholesale and retail sale of truck tyres; in-house production of metal rims for tyres</td>
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<tr>
<td>05</td>
<td>30</td>
<td>production of chemicals</td>
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<tr>
<td>06</td>
<td>42</td>
<td>production of heating boilers and air conditioning systems; wholesale supply of digital televisions</td>
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<tr>
<td>07</td>
<td>47</td>
<td>breeding and cultivation of seed; wholesale and retail seed merchant</td>
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<tr>
<td>08</td>
<td>46</td>
<td>wholesale supply of food additives</td>
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<tr>
<td>09</td>
<td>33</td>
<td>design and supply of ‘intelligent buildings’; supply of hardware and software engineering services; wholesale and retail supply of office and communications equipment</td>
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<tr>
<td>10</td>
<td>45</td>
<td>chain of supermarkets; wholesale supplier of specialist noodles</td>
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<td>11</td>
<td>49</td>
<td>photographer</td>
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<td>12</td>
<td>34</td>
<td>restaurants; production of industrial coal and pig iron; trade in coal, iron and minerals</td>
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<tr>
<td>13</td>
<td>48</td>
<td>manufacture of gold and silver jewellery, and tourist souvenirs</td>
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<td>14</td>
<td>37</td>
<td>import and sale of textiles; retail sale of electronic equipment; car repair shop; hotel and restaurant services; advertising services</td>
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<td>15</td>
<td>43</td>
<td>real estate; construction</td>
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<td>16</td>
<td>35</td>
<td>retail supply of cars and motor cycles; real estate; brick production; supply of recreational facilities</td>
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<td>17</td>
<td>35</td>
<td>trade in coal and iron; production of biological engineering products</td>
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<tr>
<td>18</td>
<td>40</td>
<td>educational services (private school for children aged 5+)</td>
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<td>19</td>
<td>45</td>
<td>production of aluminium and electrolysis processors; aluminium processing and plating</td>
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<tr>
<td>20</td>
<td>36</td>
<td>boiler repair shop; design and production of boilers</td>
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<tr>
<td>21</td>
<td>38</td>
<td>production of preserved fruit and fruit products, and soft drinks</td>
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<tr>
<td>22</td>
<td>67</td>
<td>production of iron moulds, cast-iron clamps, and zinc-plated fittings and machinery</td>
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<tr>
<td>23</td>
<td>50</td>
<td>manufacture of pigments</td>
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<tr>
<td>24</td>
<td>50</td>
<td>manufacture of cast-iron fittings</td>
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<tr>
<td>25</td>
<td>49</td>
<td>manufacture of cast-iron fittings</td>
</tr>
<tr>
<td>26</td>
<td>37</td>
<td>coal-mining; iron and coal traders</td>
</tr>
<tr>
<td>27</td>
<td>37</td>
<td>retail sale of sportswear and sports equipment</td>
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THREE ILLUSTRATIVE CASE STUDIES

Case study1: Mr A

♦ History, endowments, and activities: Mr A is Chairman of the Board of a large group of companies with 1,500 employees. He began his career in the private sector in 1986 with the import and sale of textiles using personal savings of RMB. 5,000 (about £400 at current exchange rates). He formed an unregistered (i.e. unofficial) private company in 1989 when he established a small electronic equipment shop, followed by a car repair shop in 1991. Since then, his company has expanded rapidly to embrace: the franchised distribution and sale of car parts and accessories; a car customisation service; the manufacture of car parts; car importation; car rental; hotel & restaurant services; and advertising services. The major source of capital to fund his expansion has been a group of 100 ‘partners’; but Mr A is “the big boss”, commands complete loyalty, and takes all major decisions himself. With his success, the capital offered by banks to Mr A has increased (“I could get RMB 20m easily”) such that about 30% of current assets are in the form of bank debt; but Mr A uses a network of different banks “so they have to compete for me.”

♦ Property rights: Mr A has ‘use rights’ of the land on which his buildings are located; these can be purchased for 50 years at a time. The kind of use to which the land is put is vulnerable to political intervention, although Mr A’s connections and influence make intervention unlikely.

♦ Monitoring & enforcement: Business deals are accompanied by written agreements, but trust and cooperation, supported by personal reputation, conventions of business practice, and the size and robust market position of the company are primary in enforcing the good behaviour of business partners.

♦ Alliances: Mr A is Vice-President of his local Association of Industry & Commerce; he is a Member of a Youth Enterprise Association, the Council of Private Enterprise, the Automobile Engineering Institute, and a Gentlemen’s Club (which meets in his hotel). He describes as important to his success his relationships with state-controlled firms, a variety of other firms, and the village community; but he describes his relationships with key individuals as essential. Mr A is well connected to the Party (“If there’s a policy problem, we’ll ask the government for help and urge them to modify their policy”). A key tool of leverage is his willingness to pay taxes and the large amount paid.
Case study 2: Mr B

- **History, endowments, and activities:** Mr B is a graduate of the prestigious Shanghai University. In 1992, he opened a small restaurant with personal savings of RMB 10,000 (about £800) enabling him to accumulate a further RMB 100,000 with which he opened a larger restaurant. The mid-1990s saw an increase in the level of uncertainty in the sector and so he diverted his resources into the production of industrial coal and pig-iron when he saw an opportunity for entry into this erstwhile state-monopolised sector. His brother helped with a loan. The brother has already formed a private firm offering taxation services, and “he transferred his business networks and debts” to Mr B’s firm. All loans and debts incurred via the brother were rapidly repaid from profits. Mr B observes that his major problem with expansion has been gaining access to capital funds at the right time. Mr B now has 250 employees, the majority of whom are picked up as excess labour from the state-controlled sector. Employees receive generous wages as a reward to good performance, but also in bad times “to encourage them”. He particularly values their willingness to alert him to investment opportunities.

- **Property rights:** Mr B faces serious problems in obtaining enough land to meet his expansion plans, and insecurity in its use as a result of poorly defined land rights.

- **Monitoring & enforcement:** Business deals are supported by verbal agreements. Mr B observes that monitoring is easy because most products are standardized, but that mutual trust, cooperation, and flexibility, together with personal reputation and honesty, are vital to success.

- **Alliances:** Mr B’s relationships with firms and individuals in the state sector are vital to his success since he is dependent on them for access to resources and for market entry; for their part, the state-owned enterprises must barter for Mr B’s products due to lack of cash. He is also dependent on good relations with township governments, village heads, and villagers in the areas where his factories are located since otherwise “they will cause trouble” over land use and transport issues. Mr B’s relationship with his brother was essential when he first began as an entrepreneur because he was deemed to be an outsider as a result of his period in Shanghai; this connection is less important “now that I have established my own networks”. Township and village enterprises are important customers; these are linked into a network and, since it is the network with which he conducts business, personal reputation and ‘connectedness’ within this network are vital to success.
Case study 3: Mr C

♦ **History, endowments, and activities:** Mr C's firm was originally a state-owned enterprise, founded in 1957 with 6 employees. Ten months ago, it was bought out by the 45 managers, each of whom had a small amount of personal savings; but Mr C is the largest shareholder (with 60% of shares) and the principal decision-maker. The firm now has more than 1,000 employees, most of whom had been discarded by state-owned factories in the locality. The firm produces iron moulds, cast-iron clamps, and zinc-plated fittings and machinery, which are supplied to customers throughout China and in Europe. It has a robust market position which Mr C claims is due to his willingness to introduce Western technology.

♦ **Monitoring & enforcement:** Agreements to trade are supported by written contracts, and regular inspections of Mr C’s premises. But since many of his customers are ‘old friends’, mutual trust, cooperation and flexibility play a major role in the success of the firm.

♦ **Alliances:** Mr C builds on his long-established connections with the State and within state-owned enterprises to maintain the valuable customer and supplier base he inherited and has since expanded. He is a member of the Committee for Power Line Materials of the Ministry of Power, and has been appointed the sole manufacturer of power armour clamps for the Ministry. Mr C drew on personal connections in order to secure the private water and power supplies which are vital to his rurally-located operation. Good relations with the village authorities recently enabled him to build a road connecting to the main highway. Mr C observes that human resources are most important and has good relations with the Workers Union, as well as the Consumers Association and his Trade Association. Political influence at the local level is also important to Mr C’s enterprise; he is a loyal Party member and proud of the large pictures of Marx, Lenin, Engels, and Mao displayed in his office.
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