WHOM ARE WE DEALING WITH?

SHifting ORGANisATIONAL FORMS IN CHINA’S BUSINESS SECTOR

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INTRODUCTION

China’s economic transformation has led to firms taking a multitude of different forms, some of them quite bewildering to Western observers.

- Listed companies need not indicate that they have private shareholders (Opper in chapter X);
- incorporating a firm can be seen as a way of setting up a partnership (Greeven in chapter X);
- a state-owned enterprise (SOE) can be a steel plant employing 10,000 and under the control of a ministry, or a municipal power station employing 35;
- private firms are usually those whose assets are predominantly in private hands, but they can also be parts of collective firms contracted out to a private manager (Goodman in chapter X);
- the term “cooperative” might suggest that a local community operates a firm, but it is sometimes used to describe a multi-market company or a holding company managing an asset portfolio (Hendrishcke XXX);
- a foreign/domestic joint venture need not always involve a partner from outside the PRC, sometimes the “foreign” partner is actually a domestic firm with a subsidiary registered in Hong Kong (Zhang in chapter X).

In short, nothing is what it seems in Chinese business. Any attempt to analyse the existing and future business sector must first collect firm-level data, then understand the many new organizational forms for which the rest of the world has no facile descriptor.

That China’s economic transformation led to a multitude of different business forms should not be surprising. They evolved as the Chinese government haltingly dismantled its socialist planned economy which had previously known only one type of a firm — the bureaucratic organisation operating as part of a larger and superior bureaucracy. Even today, such state firms (SOEs and collective enterprises) are still contributing 36.3 per cent of GDP, while the private sector (i.e. firms whose assets are held by domestic or foreign private owners or institutions) adds up to 61.5 per cent (2003 data from OECD 2005, Tab. 2.1:81). What is surprising, however, is the multitude of ill-
defined organisational forms that fall somewhere between conventional socialist firms and what Williamson terms “market-conforming firms”\(^1\) — between hierarchy and the market, to use the Williamson (1985) terminology. Until recently, these types of firms have been badly treated in economics as well as in organisation theory, and often ignored in studies of economic transformation. They have been regarded as “anomalies” which reflect corruption (e.g. Li 2005) and local state intervention (Oi 1995; Walder 1995) or as “hybrids” which will disappear once the market mechanism functions more effectively (Powell 1990). Transaction cost economics (Williamson 1985) is nonetheless relevant, as it shows that firms dealing simultaneously with contracts, incentives and governance structures need to take on different forms if transaction costs are to be minimised (Aoki 2001). Organisational ecology (Carroll and Hannan 2000), on the other hand, draws attention to changes in the resource environment and the availability of market niches to explain the formation of new organisational populations and their subsequent survival.

It is time to take a step forward in terms of defining organisational forms in China, and in understanding the changes in these forms over time. Both transaction cost economics and organisational ecology can be helpful in this regard. Recently, researchers have regained interest in defining forms (e.g. Hannan, Pólos, and Carroll 2006), but the situation in transitional economies has received scant attention and is less clear-cut. From a theoretical point of view, studying transitional economies such as China is of great importance because these contexts are characterized by weak selection mechanisms (Krug and Pólos 2004) where one can isolate a specific kind of transaction costs, namely those specific to the economic transformation process (‘transformation costs’ in the terminology of Grabher and Stark (1997)). For ecologists, transition economies such as China offer ample opportunity to study the process of identity and boundary formation with respect to organisational forms which might not be viable in any other context.

In the case of China, the study of organisational forms is of more than academic interest. Managers and entrepreneurs badly need to know what form China’s future business system will take. Will a few large companies, perhaps even Chinese

\(^1\) Market-conforming firms in what follows is a label used for the kind of firms one finds in functioning market economies and whose organisational form is assumed to reflect transaction cost minimization of the kind Williamson (1985) analysed.
multinationals, dominate the business sector? Or will the market be driven by a multitude of small and middle scale firms as is the case in Taiwan? Moreover, will some of the so-called hybrids survive, and by doing so add to the diversity of the world’s market economies? And finally, does the economy need different kinds of firms because of the different culturally determined ways Chinese economic actors organise production?

This chapter will apply two theoretical approaches to categorizing organizational forms in China: transaction cost economics and organisational ecology. Between them, they can account for the many hybrid organisational forms that have emerged in China. A market space will be defined which can then be applied to develop a dynamic analysis of organisational change in China based on the principles of organisational ecology. The chapter ends with a discussion whether the two approaches can be combined, and whether such a combination might allow empirical tests of their utility.

IDENTIFYING ORGANISATIONAL FORMS IN CHINA

Why should we try to single out different types of organisations (organisational forms) in the first place? The simple observation that in essence every organisation is unique ignores the fact that some organisations are clearly more similar than others and that meaningful social (aggregate) entities can be distinguished within the world of organisations. These social forms are meaningful because the organisations they describe respond similarly to environmental variations and share a common fate (Hannan and Freeman 1977). Moreover, by delineating organisational forms, we can learn more about general patterns of economic and social change, as these patterns correspond closely with the diversity of forms (Grabher and Stark 1997). According to Grabher and Stark (1997), transition economies with greater diversity adapt more easily to environmental change because their variety of organisational forms can be seen as a repository of available solutions for coping with the uncertainty inherent in environmental change.

Delineating organisational forms is by no means an easy task. Of course one can always distinguish between organisational forms in hindsight. For example, one could *ex post facto* apply statistical techniques such as cluster analysis to group organisations on
the basis of any underlying dimension. Such an approach, however, provides little guidance in recognizing new forms as they evolve. For this, we need a sharp definition or some guiding principles of categorization. First-generation theories in organisational ecology mainly focused on structural features of organisations. Hannan and Freeman (1984), for instance, proposed categorizing an organisation in terms of 1) its stated goals; 2) the forms of authority within the organisation (its governance structure in the language of transaction cost economics), 3) the core technology used to transform inputs into outputs (its production function), and 4) its marketing strategy. These four features stand in a rough hierarchy, where goals are regarded as the most highly constrained element of an organisational form, while marketing is much less subject to constraints. Similarly, transaction cost economics (Williamson 1985) distinguishes between different types of organisation on the basis of two behavioural assumptions (opportunism and bounded rationality) and three context-specific variables (uncertainty, asset-specificity and frequency of contracts). Transaction cost economics subsequently argues that the most efficient form is the one that minimizes the transaction costs generated by context-specific variables — the costs incurred in making economic exchanges.

In contrast with these approaches to delineating forms, recent advances in organisational ecology have increasingly recognized that structural elements are not the key to defining forms, but that instead the social perceptions of outsiders such as industry regulators, critics, consumers, or activists matter more. For instance, Pólos, Hannan, and Carroll (2002) have defined organisational forms as cultural objects that are subject to social norms. This approach is based on the assumption that the social support for an organisational form has a strong impact on the survival chances of organisations adopting that form.

There are certain well-established organisational categories, such as the old SOEs and foreign-owned enterprises, which certainly can be considered as distinct organisational forms in China. From an identity perspective, it is clear that SOEs, as remnants of the socialist past, are distinct from the many new organisational forms which have emerged as a result of China’s business policy reforms. Similarly, foreign firms have an identity distinct from their local counterparts. For instance, Kuilman and Li (2006) in their study of banking in Shanghai, note that accounts of the Shanghai banking
sector, such as those found in histories of banking in Shanghai as well as in modern media reports, invariably apply the categorization of “foreign” and “local” banks. This difference in social identity reflects structural differences, as these different forms of ownership convey much information about differences in structure, size, corporate governance and employment practices. How, then, to define identities for the multitude of organisational forms which have emerged during the transformation process?

Both approaches to defining organisational forms are helpful when dealing with organisational forms with sharp identities, but both display limitations when it comes to (potential) forms with less sharp identities, such as some of the forms in China’s collective and private domains which in what follows will be called hybrids. Structural approaches (Williamson 1985, Hannan and Freeman 1984) are in this context of limited explanatory value, taking into account the results of empirical research in which most of the firms studied changed their ownership and their products more than twice during the course of the study. But defining forms in terms of their social identity also has its limitations. It has been argued (Krug 2006) that firms are the outcome of ongoing institutional change in the political arena, and of organisational/institutional innovation in nascent markets. With the exception of the old SOEs and conventional foreign-owned enterprises, all other firms in China would therefore have a weak organisational identity, suggesting a dynamic view of how organisational forms are chosen. Moreover, the official data are of limited use in applying this perspective, as they still link firms to administrative levels and frequently change their classifications. The original commune enterprises, for example, were re-labelled township and village enterprises (TVEs) in 1984, but today’s TVEs are private companies, no longer managed by a township (see also Goodman, chapter XX).

Given these considerations, only close institutional analysis can help in identifying and singling out (potential) organisational forms in China’s collective and private domain. Such an analysis should be sensitive to structural factors determining organisational form (the core features of Hannan and Freeman (1984) or the cost structure emphasized by Williamson (1985)) and identity differences between forms.
(Hannan et al. 2006). This chapter will therefore make use of the fieldwork presented by Krug (chapter X) and of the analyses of the other chapters and should be read as a cautious first attempt to model the process of organisational change that accompanies economic transformation.

**(POSSIBLY) EMERGENT ORGANISATIONAL FORMS.**

Seen from the transaction cost perspective, different organisational forms reflect the organisational choices of entrepreneurs or owners seeking the governance structure which will minimise transaction costs. In order to show that transaction cost considerations dominate organisational choice, empirical evidence is needed to show that Chinese firms do react systematically to changes in the institutional environment. Another test is to see whether foreign firms in China react similarly once they are exposed to a similar set of transaction costs, or whether similar forms have evolved in other cultural settings. In fact, the database is too small for a comprehensive study, but Krug’s fieldwork (see chapter XX) offers enough illustrative evidence to claim that the forms chosen reflect transaction cost considerations of a particular kind — namely, those which are generated by the transformation process itself. It thus appears that it is not so much the Williamson type of transactional alignment which matters most to organisations (Silverman, Nickerson, and Freeman 1997; Argyres and Bigelow 2006), but instead the minimization of transformation costs (cf. Grabher and Stark 1997).

The fieldwork shows (see Krug, chapter XX) that managers do indeed choose the organisational form which they feel best fits the external environment, in the sense that they opt for a governance structures which promises to effectively cope with

- change in the political architecture. This refers to a governance structure that allows the firm to expand its local nexus, exploit regulatory arbitrage, but also to get access to bureaucratically controlled resources and local legislation
- diversity and change in their nascent markets lack of market information, or asymmetric information, lack of or the emergence of transaction services (North
2005), such as independent commercial banks, lawyers, brokers, or marketing services, whose effectiveness can determine the return on investment in networks or political alliances. The profitability of network co-ordination simultaneously determines whether and which activities get co-ordinated by markets, i.e. the price mechanism.

- mobilising investment. As long as the state does not protect private property rights, other means need to be found that act as “surrogates” in the sense that they similarly define incentives for investment while limiting moral hazard
- innovation
- generating commitment, i.e. constraining opportunism.

Table 1 displays some patterns of organisational choice which can be linked to these uncertain features of the external environment. It offers a summary of the kind of transaction costs Chinese firms try to cope with through their choice of organisational form. With the exception of the SOEs and the market-conforming firms (foreign or domestic), which are mutually exclusive, the other organisational forms can be established separately or can be combined.

Others have argued that to mitigate risk by spreading operations across several jurisdictions is compatible with all kinds of ownership structures, so long as ways can be found to solve the principal-agent problem (Stark 1996). Offering shares free of charge to local decision makers informally is a powerful means to harden property rights compatible with operating across jurisdictions, or even internationally, yet still subject to considerable Communist Party control (Opper in chapter XX).

Table 1 here

Not all firms are dealing with the same kind of political architecture, and competitive markets develop quicker in one sector than in another, so not all firms have the same ability to form or enter equally effective networks. A diversity of organisational forms (as has been proposed by Krug and Hendrischke 2006) is only a natural consequence. Thus, for example, as long as banks are still controlled by local regulators, access to bank loans in one location may best be secured through political deals with
local government agencies, while in other jurisdictions where the local state no longer interferes with lending practices, access to bank loans may depend on conventional economic calculations. In the first case firms have an incentive to invest in alliances with local government agencies, in the second they have an incentive to invest in collateral and competent cost control. In a local environment characterised by “interventionist” government agencies, protecting property rights may involve offering “shares” to local politicians. All in all, organisational choice in China reflects a search for the best match with the external environment (cf. Hannan 1986) or, more precisely, a search for the most effective way to minimize transaction costs that are specific to political control and the procedural uncertainty that characterise this nascent market. The diversity of the resulting organisational forms reflects the unequal distribution of risks, business chances and incentive problems connected with missing property rights and opportunistic behaviour.

These different organisational forms are not, however, completely independent. In particular, networking generates what Milgrom and Roberts (1990) have termed complementarity: synergy effects in the sense that concentrating more on one activity increases the return on other activities (or assets). Investing in networks, for example, helps to expand inter-firm business, while at the same time increasing the value of business agreements and offering a platform for sharing hard-to-exchange knowledge. This can, in turn, enhance the value of intangible assets such as influence on the political sector or reputation. In this way, offering crop sharing contracts to managers of TVEs was originally seen as a device to mobilise and secure scarce managerial talent, but at the same time increased the “returns” from privatising formerly collective assets. There are cases in which a single firm has embraced all different organisational forms, being at once

- incorporated (a limited liability firm),
- a multi-market firm (with operations spread across industries),
- a geographically dispersed firm,
- a firm whose expansion leads to subsidiaries with discrete ownership structures, each of which acknowledge local government agencies as shareholders,
- a network firm whose activities are co-ordinated by long-term agreements which are governed via informal institutions,
indicating a “generalist” approach that is expected to maximize survival chances.

The organisational ecology perspective comes to a similar conclusion. Stark (1996) notes that in post-socialist societies, savvy strategists adopt robust identities that potentially correspond to many different organisational forms. Hannan, Pólos, and Carroll (2006) developed the notion of grades-of-membership, in which social actors can be a partial member of one organisational form while also partially displaying the features of other forms. In post-socialist societies, having a low grade of membership in multiple forms can be a way of ensuring at least some degree of legitimacy when dealing with a rapidly changing environment (Stark 1996). In short, having a weak organisational identity may sometimes actually be a strength in a transitional economy. As has been argued by Krug (chapter X), entrepreneurship in China does indeed involve finding ways of identifying and coping with ‘volatilities’ in the environment as much as converting a new product idea or a new technology into tradable products or processes. Entrepreneurship here refers to the ability to establish organisations that can identify and monitor volatile key resources and search for governance structures and routines which can efficiently cope with external shocks or variance in the behaviour of potential business partners or government agencies (see also Casson 2005, p.335).

Such organisational or corporate governance arrangements provide an explanation for the lack of distinct and sharply defined organisational forms in China’s new business sector. According to organisational ecology, new organisational forms are most likely to come into existence when the organisations requiring that form do not already derive part of their identity from other, already existing forms. To turn the argument around, as most firms reflect transformation of an inherited socialist form, hybrids would be expected to evolve, rather than new distinct forms, a finding that is compatible with the transaction cost argument introduced earlier.

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2 McKendrick and Carroll (2001), for instance, in a study of disk array producers, concluded that in this case no new organizational form came into existence because many of the organizations involved in producing disk arrays were also involved in other activities ranging from the manufacture of computers and motherboards to distribution and retail activities. From a social identity perspective, such a lack of perceptual focus impeded the development of a sharply defined and coherent organizational form for disk array manufacturers (McKendrick and Carroll 2001).
MARKET SPACE IMAGERY AND ORGANISATIONAL CHOICE

In order to understand the dynamics of organisational forms in China, it might be helpful to envision a market space in which organisational forms can be mapped. Organisational ecology has used this approach extensively, starting with Carroll (1985). In a transition economy, a market space would usually encompass the central bureaucracy, local government agencies, networks, employees, suppliers, consumers, and other actors and institutions that are potential providers of resources. A market space can in principle be characterised by several dimensions (see Nooteboom and Péli 1999), but in the interest of simplicity this discussion will be confined to one dimensions only, namely the state socialist vs. market orientation of the resource providers (Figure 1). At one extreme, resource access is controlled by ‘political-bureaucratic’ allocation, at the other by market allocation, while the ‘market centre’ is dominated by network allocation that might or might not make use of the market or bureaucratic mechanisms. The market space in transition economies is furthermore assumed to be characterised by a normal distribution of physical assets, finances, and human capital along this dimension.

Empirical studies have shown that, depending on the position along the state socialist vs. market continuum, there is an appeal to a particular set of political and economic actors.

Organisations occupy positions along these dimensions. On the right-hand side we find organisations that operate under pure market conditions. Only a few companies in China can claim to work in such an environment, most probably found in foreign trade where the WTO regulations encourage price competition and lower entry barriers. For convenience, the organisational form of such companies can be called “market-conforming”. At the other extreme are (unreformed) SOEs still subject to plan quotas and

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3 On the product-level, such an approach resembles that of Hotelling (1929), which was later to be extended to account for a potentially infinite number of dimensions by Lancaster (1971), where each dimension represents a product characteristic.

4 We assume a unimodal resource distribution in the interest of simplicity. Of course it is also likely that in a transition process a second peak emerges. This possibility of a bimodal resource distribution is considered by Dobrev (2001).
controlled by government ministries. As the analysis presented in earlier chapters suggests, a multitude of different organisational forms has emerged after regulatory reforms acknowledged the legitimacy of organisational choice, and the firms involved can be called hybrids. As argued above, their weak organisational identity and “messy” boundaries do not indicate market failure, let alone lack of innovation or competence. The hybrid form was chosen because such corporate governance promises to better cope with the political and economic diversity firms are confronted with in the transition period.

If a set of organisations occupies a similar position along this continuum and has a distinct social identity, we can meaningfully speak about a separate organisational form. Figure 1 portrays two hypothetical resource distributions along our chosen dimension, focussing on three separate forms only, namely the SOEs, the market-conforming firms (at the beginning of the reform period exclusively foreign firms) and the broad category of hybrids which combine all or some of the features described earlier. The left bell-shaped curve is clearly the pre-reform situation (at time $t_0$) in which most resources were assigned to firms with a state socialist ideology, i.e. the SOEs. The SOEs were in this period clearly positioned in the market centre, defined as the place with the peak in the resource distribution. Figure 1 also displays a second bell-shaped curve in which the centre of the market has shifted on the state-socialist vs. market continuum, reflecting the more contemporary period (at time $t_1$). In this particular case, hybrid organisational forms and market-conforming firms have started to attract a larger proportion of the available resources. As a result, SOEs now operate on the periphery of the market, while market-conforming firms have shifted from the periphery toward the centre. That hybrids attract most of the resources is not only predicted by transaction cost and organisational ecology analysis, but supported by the many empirical studies which have gone beyond the official statistics.

From the transaction cost perspective, the position of firms in the market space reflects, ceteris paribus, organisational choice by which they respond to the different allocation mechanism of resources. State allocation via quota or, more precisely bureaucratic means defines one extreme; the priced mechanism defines the other extreme
and the point from which onwards firm act within the Williamson scenario of organisational choice. The middle is characterised by co-existing and overlapping allocation rules when ad hoc bargaining can offset “official” regulation but also limit the functioning of markets. From the perspective of firms there is the need to simultaneously ensure access to resources via all three forms. As the use of markets, bureaucratic hierarchies and networking is not costless, they will search for such an organisational form which minimises the respective transaction costs. Moreover, firms of different size, ownership, or operating in different sectors will face different transaction costs. Thus, for example small firms in the consumer goods sector where political agencies do not interfere depend more on competition in product and factor markets than large firms operating in state controlled sectors or depending on state controlled input or SOEs as main customers. Subsequently firms have an incentive to search for such a corporate governance structure, i.e. organisational form that allows making best of use of all three kinds of allocation mechanism.

It is the need to flexibly respond to the three different forms of allocation mechanisms: bureaucracy, networking, and the price mechanism which explained the diversity of the hybrid forms as well as the fact that firms choose to keep the boundaries of their organisational firm open. Transaction cost considerations also explain why firms today congregate around such an organisational form, the hybrids, which make best use of networking as most effective means to bridge bureaucratic control and market competition and selection.

**THE DYNAMIC PERSPECTIVE**

From a dynamic perspective, we expect two types of changes over time which should ultimately affect which organisational forms are successful and which are not. These shifts are not mutually exclusive, but will for analytical reasons be treated separately:

1. **A shift in the resource base.** Ongoing reforms in the form of further liberalisation and less state intervention liberate resources as they become no longer politically or bureaucratically co-ordinated. Such moves lift an income constraint or shift the
opportunity set, leaving more resources for network or market co-ordination. Subsequently, the value of political capital declines leaving fewer resources at the disposal of SOEs. This does not necessarily mean that the SOEs will disappear. As long as the state protects them and nurtures them with cash, bureaucratically distributed input or personnel, they will remain and claim a part of the total resources available. The shift in the resource base does not, however, depend on further reforms alone. Increasing the share of income and investment outside state control increases the stock of resources open for network or market co-ordination. The boundary of network organisations and market-conforming firms is fluid, so when, for example, networks find it advantageous to make use of the market by establishing and then contracting out to quasi-independent competitive firms (Hendrischke in chapter X), the move to the right must not lead to a skewed distribution around an unchanged mean. One such move can be expected once liberalisation of the financial sector has started. The number of organisational forms relying on state allocated financing will decline, while ‘private equity’ firms on the right of Figure 1 will increase, leading to more resources being allocated according to the economic rationale of the capital markets (rate of return, creditworthiness, availability of collateral). The majority of firms will, however, still depend on bank loans, access to which might still depend on who controls the banks, a process on the left side of the continuum. Another substantial and increasing body of firms depends on capital accumulated within networks or brokered by networks, for which they have to compete. They too, therefore, need to behave as if they were market-conforming firms.

2. **A change in organisational form** as firms attempt to compete for the mean. As firms seek the mean of the resource distribution (i.e. the market centre), a change in organisational form will be needed. Two examples can illustrate this. One is the case of the TVEs which, being collective firms, start well to the left of the mean. In the late nineties, when increasing competition for customers, suppliers and capital threatened their resource base, they used management buy-outs to mitigate commercial risk and as a means of gaining legitimacy. This helped them to mobilise additional investment and secure bank loans. In other words, they moved
from the left of the mean toward the right. The multinationals provide another case. At the beginning of the eighties it was expected that the multinationals could use their well-tested blueprints and enter the Chinese market via joint ventures mostly brokered with representatives of the central government. Yet, once having invested in China and thus become vulnerable, they quickly learned that they needed to localise their operations and invest in alliances with local government agencies or local networks. As a result, they came to look more and more like Chinese companies, investing in unrelated lines of production, going for a wide geographical spread, becoming involved in local politics, and joining Chinese-foreign networks. In other words, they moved from the extreme right of the continuum toward the middle. It is worth stressing that this phenomenon of foreign firms imitating or blending with domestic organisational forms contradicts the claim that the Chinese form of business networking is China-specific⁵. It rather supports the claim that in China too, organisational choice follows transaction cost considerations, in particular transformation cost considerations (Grabher and Stark 1997).

What determines whether an organisational form will ultimately be successful in the market space? One of the characteristics of the hybrid organisational forms is that they operate under weak survival constraints, insulated to some extent from market competition and political persecution. As a result, these hybrid forms survive longer than they would in an environment with strong selection pressures. Only SOEs, which can rely on ongoing state control formulated at the central level, and market-conforming firms working in generally accepted markets are exposed to one constraint only. In contrast, the hybrids aim at a position where they can leverage their economic power (over investment and job creation) and their tax payments to wield political influence. Their political power can then feed back into economic power, especially dominant position in a sector.

⁵ The most influential articles are Fan (2002); Guthrie (1998); Lechner and Dowling (2003); Luo (1997); Park and Luo (2001); Peng, M. (2001); Peng, Y. (2004); Tong and Yong (1998); Tsang (1998); Xin and Pearce (1996); Zhou et al. (2003).
It is this effect that limits the explanatory power of transaction cost or public choice approaches that rely on exogenously determined market or political constraints. Fieldwork has demonstrated that such constraints can be weakened via negotiation, so then other analytical tools need to be employed. Institutional game theory (Bates 1998; Greif 1998; and also the contribution by Zhu and Krug in Chapter XXX) confirms that changes in organisational form should reflect only partly a systematic response to changes in the relative prices of employing different institutions. Changes also occur as the result of the interactions among firms and political agents.

From a dynamic perspective, the question of organisational change and survival is directly linked to the transformation process. Not any change in organisational form would be welcomed, but only those which result in market-conforming firms moving from the extreme on the socialist-market continuum toward the middle, dominant form in their industry or sector\(^6\). As previously stated, “market-conforming” here refers to a category of firms whose organisational choices reflect the set of transaction costs singled out by Williamson (1985). Their shifting to the centre depends on three underlying processes: first, that the already existing market-conforming firms outperform other forms and increasingly gain market share (a selection effect); second, the new hybrids anticipate the better performance of market-conforming forms, and therefore imitate their organisational form, a move that needs to be negotiated between “owners”, shareholders and the firm’s networks; third, new firms, in particular in the “transaction services” which facilitate impersonal trade need to emerge (North 2005, 91) adding to the number of market-conforming firms while at the same time increasing the effectiveness of market co-ordination when compared to network co-ordination (a specialisation effect).

While economics focuses on the marginal firm, organisation ecology reminds us that success in the market is mainly a function of competitive behaviour. Competitive overlap is among the main causes that determine which organizational forms survive in a market. In this connection, Hannan and Freeman (1977) have invoked the principle of ‘competitive exclusion’. This principle states that when two similar organizational forms

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\(^6\) They need not to be the only organisational form, so long as they ensure market competition.
occupy the same position in the market space, one of the two organizational forms will prevail and the other will disappear. Recently, Ruef (2006) confirmed this principle in his study of the demise of organizational forms, a study which also considered other possible explanations, including the decline of material resources and lack of political support.

Both ongoing reforms and private investment will set incentives for or remove constraints of firms build around private capital, while increasing competition will force firms to look for clearer boundaries in particular when it comes to political interference. Does this mean that firms with a clearer identity will emerge? At the beginning we found only two kinds of firms with a strong identity, both at the tails of the distribution, namely the foreign firms and old state-firms. After almost 30 years of transformation we find some more, namely state owned firms organised as stock-listed companies on the left tail and private companies – stock-listed or limited liability companies with a clear product profile and increasingly more with a brand name at the right hand side of the distribution. While transaction costs economics would stress competition as crucial factor behind the change in organisational form, organisational ecology might add legitimation. Thus, undoubtedly the main reason behind the state stock-listed companies which in particular when Hong Kong or New York listed, attempt to exploit market chances outside China. Likewise, when the incorporation of firms is seen as a requirement for getting bank loans, or when the increasing use of written contracts asks for a legal person as contract partner, firms have an incentive to better delineate their identity. Thus, parcelling out well-defined firms helps to solve some asymmetric information problems leading to lower transaction costs. On the other hand, private firms have also profited from increasing social legitimation when even in official Party documents their existence is not only acknowledged but regarded as beneficial for overall economic development. Thus, more firms with a clear identity can be expected to emerge at the tails.

The empirical results discussed in chapter XX have shown that it is less competition for customers that characterises competition in the business sector, but rather competition for capital in all its forms. In the transformation context this refers to tangible and intangible assets, and a set of resources which can be labelled as political
capital, social capital, or market capital. In Figure 1, the left side refers to political capital. Any repositioning involving a combination of political, social and market capital implies a decreasing role for political capital and an increasing role for social capital, until at the other extreme firms rely primarily on market capital, an organisational form that best fits a market environment. Based on empirical studies, it is assumed that the market centre is defined by a combination of accumulated political, social, and some market capital, a resource pool which the hybrids can best exploit. On the left, political capital such as position within the hierarchy of bureaucratically organised production and distribution is essential, and SOEs (almost by definition) represent the best fitting form. On the right, the business environment is characterised by effective markets for risk, functioning liability and tort laws, open entry for firms and functioning market mechanisms. In the end, the greater flexibility of market-conforming and network firms will lead to their occupying the market centre, and best following the move of the market (Krug and Pólos, 2004, p.88). SOEs will find it much more difficult to adapt in this way.

CONCLUSION

The objective of this chapter has been to move a step forward in defining organisational forms in China and in understanding changes in the organisational landscape over time. To achieve this end, we have applied insights both from transaction cost economics (Williamson 1985) and from organisational ecology (Carroll and Hannan 2000). Transaction cost economics, which is firmly rooted in conventional economics, and organisational ecology with its roots in sociology offer different perspectives on organisational forms. While both acknowledge the role of market competition in explaining the prevalence of particular organisational forms, transaction cost economics tends to focus on efficiency considerations and traditionally has a cross-sectional focus. Organisational ecology, on the other hand, stresses social processes such as legitimacy and social identity in the evolution of organizational forms and has a longitudinal orientation. This does not mean, however, that transaction cost economics and organisational ecology are at odds. The findings of Silverman et al. (1997), for instance, suggest that organisational ecology and transaction cost economics are highly complementary. Silverman et al. (1997) have shown that incorporating both transaction
cost considerations and ecological variables in market models simultaneously can lead to significantly sharper predictions of organisational mortality.

Transactional alignment improves a firm’s survival chances (Silverman et al. 1997), and this seems to be especially so when markets are characterized by strong selection pressures (Argyres and Bigelow 2006). Grabher and Stark (1997) have argued that transactional alignment is relevant in countries with transition economies, but in these countries it concerns transaction cost considerations of a different kind, namely transaction costs specifically generated by the country’s ongoing economic transformation process.

In attempting to apply these insights more widely, it’s important to remember that the Chinese context might be too specific in terms of its culture and the predominance of networks. As a counterargument, the primacy of transaction cost considerations even in China seems to be confirmed by the quick response of Chinese firms to changing institutions and policies. The relatively smooth transition toward market-conforming behaviour of firms in the Pearl River delta (greater Hong Kong) and in the Yangtze River delta (greater Shanghai) testifies to this. Other examples are the disappearance of TVEs, and the organisational changes which have been made to accommodate foreign direct investment. Moreover, the claim that networking is the essence of Chinese business behaviour can also no longer be justified. Networking in China is an adaptation to a weak institutional architecture, and as such is not linked to the Chinese case only. There is an increasing literature on networks and business groups which, following Greif (2003), shows that networking is not just a historical carry-over from the time when there was no modern judiciary, which necessitated relation-based trade. Rather, this organisational form can be found today in countries as different as India, Mexico, Russia and France (for a more complete list and a comprehensive analysis, see Ghemawat and Khanna 1998).

REFERENCES

Argyres, Nicholas and Lyda Bigelow (2006), ‘Do transaction costs matter for firm survival at all stages of the industry lifecycle?’, working paper, Boston University.


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Table 1: Organisational Forms and Transaction Cost Generating Features of China’s Transition Economy

<table>
<thead>
<tr>
<th>Organisational form</th>
<th>Political architecture</th>
<th>Nascent markets</th>
<th>Mobilising resources</th>
</tr>
</thead>
<tbody>
<tr>
<td>State owned enterprise</td>
<td>State sector</td>
<td>Subsidised</td>
<td>Technocratic control</td>
</tr>
<tr>
<td>Township or village enterprise (early in the reform process)</td>
<td>Village-owned</td>
<td>Property right risk (political risk), and commercial risk</td>
<td>Managerial knowledge</td>
</tr>
<tr>
<td>Privatized TVE</td>
<td>Comfortable market niche</td>
<td>Expansion to other sectors and locations</td>
<td>Collaboration of political agents</td>
</tr>
<tr>
<td></td>
<td>Managers as owners</td>
<td></td>
<td>Bank loans</td>
</tr>
<tr>
<td>Multi-market firm</td>
<td>Locally embedded</td>
<td>Spreading market risk</td>
<td>Access to resources</td>
</tr>
<tr>
<td></td>
<td>Co-operation with local government agencies</td>
<td></td>
<td>Access to other business partners</td>
</tr>
<tr>
<td>Geographically spread</td>
<td>Independent</td>
<td>Expanding business nexus, spreading risk</td>
<td>Establish quasi-independent firms co-ordinated through the local community or some other network</td>
</tr>
<tr>
<td>Public/private partnership</td>
<td>Political risk</td>
<td>Asymmetric information, access to resources</td>
<td>Property rights protection by aligning the local government and the business sector</td>
</tr>
<tr>
<td></td>
<td>Local autonomy</td>
<td></td>
<td>Converting intangible social capital into corporate assets</td>
</tr>
<tr>
<td>Incorporated firm</td>
<td>Fighting state claims on cash flow</td>
<td>Establishment of corporate assets</td>
<td>Hardening property rights</td>
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<td></td>
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<td>Incentive contracts</td>
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<td></td>
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<td>Management buy-outs</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Experimentation with different firms, Competition for network resources</td>
</tr>
<tr>
<td>Network firms</td>
<td>Leveraging market power</td>
<td>Asymmetric information, scarcity of financial capital and managerial talent</td>
<td>Scale and scope economies built on non-tradable assets (reputation, influence with the bureaucracy)</td>
</tr>
<tr>
<td>Market confirming firms</td>
<td>Market economy</td>
<td>Market economy</td>
<td>Crop sharing contracts Conventional transaction cost considerations</td>
</tr>
</tbody>
</table>
Figure 1: Hypothetical Organisational Landscape in China