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## Entrepreneurship and Political *Guanxi* Networks in China's Private Sector

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## Entrepreneurship and Political *Guanxi* Networks in China's Private Sector

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### Abstract

Since the mid-1990s the Chinese government has rapidly liberalized the environment facing domestic private firms. As a consequence, many private firms have clarified their ownership relations and acquired stronger organizational boundaries. However, despite this formalization of private sector institutions, informal *guanxi* networks remain a key component in firm success. Most significant among these *guanxi* networks are political networks that connect private entrepreneurs with actors in China's political sphere.

Based on 15 case studies of private firms, we argue that two seemingly contradictory trends are emerging in the development of China's private sector. On one hand, legal, political, and market structures are becoming more institutionalized. On the other, the use of political *guanxi* networks to further firm success remains essential. To examine these trends we present three in-depth case studies. Based on these case studies we argue that the formalization of private sector institutions and the nurturing of political *guanxi* networks are not contradictory. Rather, formal institutional arrangements are likely to meld with the continued use of *guanxi* networks, thus lending China's emerging capitalism its unique characteristics.

## Introduction

Over the past ten years private firms have marched from the fringes of the Chinese economy to take center stage. Accompanying this march has been the institutional evolution of Chinese private firms. Faced by political uncertainty, insecure property rights and overt government discrimination, many private firms in the early stages of development during the 1980s and 1990s chose murky ownership structures and relied on collusive practices with local governments. *Guanxi* networks<sup>1</sup> with government officials and economic actors emerged as a necessary ingredient for protecting private ownership and gaining access to commercial opportunities.

Since the mid-1990s, economic, legal, and political initiatives have allowed private firms to clarify their ownership structures and attain a certain degree of organizational clarity *vis-à-vis* their social and political environments. This gradual institutionalization of the internal governance and external environment of private firms suggests that *guanxi* networks with local governments should diminish in importance. This view is reflected in some of the recent literature on China's reforms, such as in Guthrie (1999). While his study focuses on a narrow section of managers in urban state enterprises, he extends his arguments and contends that the centrally led construction of formal institutions is diminishing the importance of *guanxi* networks for accomplishing business tasks in China.<sup>2</sup>

We argue in this paper that the history of private sector discrimination, the persistence of institutional ambiguity governing private firms, and intense market competition are continuing to make *guanxi* networks a key factor influencing firm success. Especially *guanxi* networks built around entrepreneurs, local government officials, party cadres, and political representatives – political *guanxi* networks – are noteworthy.

Two seemingly contradictory trends can be discerned. On the one hand, the use of contracts, formal institutional arrangements, and modern corporate forms is increasing in China. As a result, many private firms are clarifying their ownership and institutionalizing the use of formal legal mechanisms. On the other hand, the use of political networks continues as a necessary element in a firm's commercial success. In a sense, the practice of *guanxi* is being adapted to the structural needs of China's emerging capitalism (see Yang 2002). *Guanxi* are melded with newly established formal institutions and serve as a key mechanism through which wealth is accumulated. In the future, the penetration of *guanxi* networks into all aspects of business-industrial activities might even be perceived to lend the emerging institutions of Chinese capitalism their competitive advantage.<sup>3</sup>

We will begin with a brief overview of the history of China's private sector, outlining several major evolutionary trends. Our arguments will then be illustrated by three case studies of private firms in a western Chinese province. While these case studies cannot produce conclusive evidence pointing to the salience of political *guanxi* networks, they nonetheless generate detailed insights into the dynamics of government-business relations in China's private sector. Finally, we will end with concluding remarks that incorporate the wider findings of our sample of case studies.

## The Evolution of China's Private Sector

The Chinese economy has undergone a stunning transformation since 1978. Analysts have pointed to two fundamental structural changes characterizing this transformation (see Naughton 1999). First, the influence of the central plan has diminished and given way to market economic forces. Second, although over 60 percent of Chinese are still classified as rural residents, rural agricultural activities have declined in importance since 1978. China's economy is now predominantly powered by urban industrial activities.

Since the mid-1990s a third structural transformation has begun. Almost non-existent in the late 1970s, China's private sector has experienced rapid development. As a result, China's economic system is gradually outgrowing state ownership. China's private sector development can be divided into three phases.<sup>4</sup> During the first phase from 1978 until 1984 private enterprises were restricted to small-scale private firms with no more than eight employees, the *getihu*. The private sector was merely tolerated as an experiment and only allowed to exist in sectors where large state firms had no presence.

During the second phase lasting from 1984 until 1992, private enterprises grew in size and actual private firms (*siying qiye*) were sanctioned in 1988. However, even after official regulations on private firms were issued, many private entrepreneurs shied away from this ownership form. Private firms continued to face political uncertainty, discrimination and heavy restrictions, some of which were reinforced after the Tiananmen Incident in 1989. Consequently, entrepreneurs formed alliances with local governments and government-owned firms, creating a multitude of organizational forms. For example, many private entrepreneurs preferred to register their firms as collective enterprises, giving rise to the term "fake collectives."

In early 1992 Deng Xiaoping's southern tour (*nanxun*) ushered in a renewed push towards market reforms, which generated over time a more tolerant environment for the private sector. One important legal move came with the promulgation of the Chinese Company Law in 1994. The implementation of this law generated the conditions for convergence among the governance structures of private and state-owned firms in China. Depending on their location and size, private firms started to switch from corporate structures with murky ownership to limited liability corporations. In this process stakeholders converted their informal ownership into shareholding capital. As limited liability corporations, private firms could acquire a stronger organizational identity with respect to their political and social environment. In fact, many of the "fake collectives" opted to openly convert into private limited liability companies. New initiatives starting in the mid-1990s under the policy of *zhuada fangxiao* ("to grasp the big and let go of the small") and state enterprise *gaizhi* ("transformation") also opened the door for private entrepreneurs to buy shares in state firms. Consequently, by the year 2001 most small-scale state firms owned by county governments or below had been privatized.

One of the most significant political watershed occurred in March 1999. Following the announcement at the 15<sup>th</sup> Party Congress in September 1997 to develop diverse forms of ownership side by side, the National People's Congress amended the Chinese constitution to redefine private enterprise as an "important element" of the Chinese economy (*South China Morning Post* 1999). State ownership, though, remained

a notch above other ownership forms in the constitution, since it continued to be accorded the “dominant position” in the Chinese economy.

Recognition of China’s private sector gathered further steam as China faced the prospect of increased competitive pressures from abroad after entry into the World Trade Organization (WTO). On October 14, 2003 the Chinese Communist Party (CCP) issued policy statements that acknowledged the importance of establishing a modern system of property rights (Kwan 2003). As a result of this announcement, the Chinese constitution was amended in March 2004 to include the phrase, “private property obtained legally shall not be violated” (Buckley 2004). Although this constitutional change includes the caveat “obtained legally,” this move puts private property nominally on the same footing as state property, which is regarded as “sacred and inviolable.”

These constitutional changes triggered the promulgation of the much-awaited Property Law (*wuquan fa*) in March 2007. This law codifies earlier constitutional changes and affords equal protection to state and private property. It also gives units and individuals rights to compensation for their expropriated houses and tangible assets, and stipulates that land-use rights for residential land will be renewed upon expiration (Ng and Wang 2007). The Property Law is being followed by detailed government policies, many of which aim to give private firms equal treatment to state firms, including access to markets and sectors hitherto closed to the private sector, such as infrastructure, education, and finance.

Despite these trends toward greater recognition of private property, various studies point to how insecure property rights, government discrimination, and legal and political uncertainty have fostered a culture of opaqueness, informality, and collusion in China’s private sector. Indeed, the politically questionable status of private firms in Chinese history has resulted in many private entrepreneurs employing hybrid forms of ownership and colluding with local government institutions and officials. These arrangements have created manifold opportunities for rent-seeking and corruption. Private firms have also sought to hide their income from tax authorities, leading to opaque governance structures and the proliferation of subsidiaries in related as well as unrelated businesses (International Finance Corporation 2000).

Wank’s (1999) in-depth study of private businesses in Xiamen illustrates how *guanxi* networks have compensated for institutional uncertainty and helped to create profit-making opportunities for private entrepreneurs. Business studies further underscore the importance of employing strategies based on *guanxi* networks in China’s economy (see Xin & Pearce 1996; Tsang 1998; Davies *et al* 1995; Luo 1997). In fact, *guanxi* networks play key roles in facilitating the sharing of market information and transferring technology.

Political *guanxi* networks have remained particularly ubiquitous in China. For instance, these networks have become influential during the privatization of Township and Village Enterprises (TVEs).<sup>5</sup> Local government officials and TVE managers tend to control the privatization process up front, generating favorable conditions for incumbent managers to buy out their enterprise (Ho *et al* 2003). This collusive process is facilitated by muddled and contradictory legal stipulations concerning privatization, thus creating manifold opportunities for political *guanxi* networks to thrive.

In general, political *guanxi* networks built around private entrepreneurs, local government officials, party cadres, and political representatives enable private firms to

gain access to government agencies. In this manner, political *guanxi* networks enable firms to influence policy making, gain timely information on policy changes, access bank credit, and create greater certainty in their business environments.

Recent political moves further promise to provide opportunities for private entrepreneurs to create effective political *guanxi* networks. In addition to the constitutional changes mentioned above, the CCP gave the green light for private entrepreneurs to become communist party members in July 2001. To some extent this announcement brought party regulations closer to reality. Many private entrepreneurs already had joined the party. Some were party members when they went into business, while others were clandestinely invited by local officials to join. Nonetheless, this highly sensitive political move on part of the CCP leadership is allowing private entrepreneurs to more freely gain access to China's political structure. The cases we present suggest that this will aid entrepreneurs' ability to strategically employ political *guanxi* networks to further firm success.

### **The Cases: Research Method and Data Sources**

The case evidence presented here was generated by fieldwork undertaken between 2001 and 2007. Eleven of the 15 cases, including the three in-depth studies presented in this paper, were conducted in China's west. Another three cases were conducted in the Yangtze River Delta, while one more case is located in the Pearl River Delta. These 15 studies were supplemented by information gathered by earlier fieldwork focusing on China's state enterprise reforms. The case studies employed a standardized questionnaire based on 142 questions, divided into five sections: the history of the corporation; the process of privatization (or ownership clarification); present business conditions; corporate governance issues; and relations with political institutions and government officials.

The questionnaire was designed to provide a standardized set of questions, while also allowing room for open-ended queries. For this purpose many of the standardized questions in the questionnaire are followed by open-ended questions, allowing interviewers to probe more deeply into certain issue areas. In total, 52 interviews were conducted covering all 15 enterprises.<sup>6</sup> Interviews were conducted with CEOs, top functional managers, key planning and technical staff, as well as observers of private enterprises such as government officials and academics. Where possible, we reviewed the cases for accuracy with triangulation methodology (Patton 1987). The enterprises interviewed are mostly considered medium-sized in their sectors and are located in the manufacturing, real estate, and high-technology (software and pharmaceuticals) sectors.

For access to private firms we relied on support from research institutes and personal contacts. We cannot claim that the sample of respondents or firms is representative. All of our interviewees are liable to have applied their own filters. Especially for the first part on the history of the corporation we had to employ the recall method to construct the evolution of a firm's corporate structure and business environment. Ultimately, we feel that employing case studies and ethnographic methods is justified. The evolution of China's private sector presents a rapidly changing and



transitional context for which case studies make it “possible to discover patterns of adjustment that may be disguised by purely quantitative data” (Carlin *et al* 1995: 429).

To portray the importance of political *guanxi* networks in the strategies of Chinese private firms we have chosen three cases out of the 15 cases for in-depth discussion. These three cases are representative in the sense that they best illustrate the linkages between China’s private sector and the country’s political structure. Nonetheless, due to the limitations noted above, our contribution is meant to be exploratory, offering a unique glimpse into the key features of entrepreneurship in China’s emergent political economy.

## **The Cases: The AB Furniture Company**

In order to investigate the salience of political *guanxi* networks in AB Furniture’s development, we proceed in two parts. First, we briefly characterize the history of AB Furniture’s business scope and structure. This is then followed by an analysis of the role and impact of political *guanxi* networks on AB Furniture’s evolution and business success.

### ***The History of AB Furniture***

As with many private corporations in China, AB Furniture began as a collective enterprise. A husband and wife team – Mr. and Ms. A – established AB in 1986.<sup>7</sup> In many ways Ms. A was the driving force behind AB Furniture’s establishment. Her career began as a government official during which she was seconded to several TVEs in the early 1980s. At this time she gained knowledge about the furniture business, prompting her to start a moonlighting job selling furniture to rural areas. In 1986 she and her husband set up a small furniture factory but then rapidly moved to invest 50,000 Chinese RMB in a defunct TVE. 30,000 RMB of this investment came from the savings generated by Ms. A’s furniture sales and another 20,000 were borrowed from friends and relatives. AB Furniture remained officially under a village (*xiang*) government as a collective, although in practice Mr. and Ms. A had full operational and financial control.

Following its establishment, AB’s development can be divided into four phases. These four phases parallel the development of private firms in China in general, and will therefore be examined here in some detail. The first phase, the entrepreneurial phase, spanned the late 1980s until the early 1990s and was characterized by the gradual accumulation of capital. AB began with copying designs from furniture factories located in Guangdong Province. A marketing and management system was established. Most importantly, AB Furniture succeeded in establishing a brand name for itself. For example, the government of D City (a major city in western China) recognized AB’s furniture products as “high quality products” (*youzi chanpin*), bringing official recognition and media attention to the company in the late 1980s. Overall, AB at this time was ahead of other furniture producers in western China in terms of quality and design, resulting in a rapid expansion of production and sales.

During the second phase, lasting for most of the 1990s, AB Furniture expanded its funding channels and clarified its property rights. This phase began when in 1992 the

rural credit cooperative based in the village that “owned” AB Furniture actively sought to extend a loan in the amount of 300,000 RMB. Up until this point all capital investment had come from retained profits and no urgent need existed to take out this loan. However, Mr. and Ms. A thought of this as a good way to cultivate *guanxi* with the local credit cooperative. The loan was used for working capital and to invest in capital equipment. The next year AB moved one step further and borrowed from the same village-level credit cooperative more than 6 million RMB to lease land and build a new factory. As a result, production jumped, sales expanded, and the company’s workforce exceeded 300 by 1996.

During this phase AB Furniture was also able to further establish its brand name. In 1997 the provincial government recognized AB Furniture as a “famous brand name” (*mingpai*), an award only reserved for a small number of manufacturers. At this point AB held an 80 percent share of the furniture market in D City.

Finally, the last year of phase two saw the clarification of AB’s property rights. Due to the central government’s policy of transformation/reform (*gaizhi*), many small and medium-sized collectives and state enterprises owned at the county level or below were urged to clarify their ownership and register as limited liability companies. No formal asset valuation took place. Rather, Mr. and Ms. A negotiated a price with the village government. Although Mr. and Ms. A were unwilling to divulge the exact amount paid, they made clear that it was a token sum. The conversion of AB into a limited liability company proceeded smoothly. AB registered with 6 million Chinese RMB in capital and two shareholders, Mr. and Ms. A (each with 50 percent of shares).

AB’s third developmental phase lasting from the late 1990s until early in the 21st century was characterized by increasing difficulties. In the late 1990s market conditions changed dramatically. Within the span of a few years more than 1,000 furniture factories sprung up around D City, putting competitive pressures on AB. In addition, the tastes and demands of Chinese urban consumers started to move upscale, yielding advantages to Guangdong companies that were upgrading their designs with knowledge from abroad. Most importantly, AB’s internal management system started to fall apart. As AB grew, it generated a work culture similar to that of state firms. Workers expected the unconditional renewal of their employment terms and management became top-heavy, with Mr. and Ms. A employing many relatives and acquaintances in management positions. As a result, quality control declined and AB lost market share.

Following the initiative of Ms. A’s daughter and her husband, both of which had taken up top management positions in AB in the mid-1990s, the company moved from production into retail sales. AB invested 5 million RMB to set up a large furniture mart in 1998. However, this strategy failed. The retail outlet lost a total of more than 3 million RMB by 2000, causing AB to shut it down. The failed investment also generated a major rupture in AB’s family-based management system. Ms. A and her daughter fell out, leading the daughter and her husband to leave AB.

Changing market conditions, internal management problems, and a misguided investment strategy had ruinous consequences for AB. Within two years from 1998 until 2000 AB lost market share, accumulated inventories, and ran up debts amounting to 70 percent of assets. These problems drove it to the brink of bankruptcy. Since Ms. A’s husband faced an ongoing ailment, Ms. A hired a long time friend, Mr. P, as a new manager in 2001. Mr. P had already worked on various occasions as a manager and

consultant in China's emerging private sector. He therefore possessed a variety of business experiences and a wide network of *guanxi* in D City.

With the support of Mr. and Ms. A, Mr. P ushered in the final developmental phase of AB Furniture. He hired a long time friend of his, Mr. C, as factory manager, liquidated inventory, and decided to sell AB's factory building. Fortuitously, AB's new management knew about plans by the city government to develop the area where its factory premises were located into a major shopping mall. AB was thus able to make a 60-70 percent return on its initial investment, generating much needed capital to pay down debts and invest in the future. The new management team also set out to restructure internal operations. More than half of the workforce was laid off. Especially AB's top-heavy management was hard hit. Two thirds of AB's managerial staff were fired, including even Ms. A's brother.

With a much smaller labor force (slightly more than 100) Mr. P and Mr. C implemented a flexible labor management system. They also lowered raw material costs by about 30 percent within one year and built a new factory at the outskirts of D city. Perhaps most importantly, Mr. P hired new staff to develop the computer-aided design of furniture with the hope of making AB into a technology-leader in its industry.

The new business strategy yielded some initial success with sales increasing by 20 percent within one year. Consequently, AB's management decided to go one step further and establish a new limited liability corporation in mid-2002. The main reason given by the interviewees for this move was to lower taxes by skirting requirements to pay China's value added tax. In addition, interviewees hinted that the new corporation was meant to bring ownership relations closer to reality, with Mr. and Ms. A together owning 70 percent of the shares, while Mr. P held a 20 percent and Mr. C a 10 percent ownership stake. In 2004 all four interviewees expressed the intent to gradually transfer assets to the new corporation, thus hollowing out AB furniture.

Despite an impressive turn-around in sales and profits, AB Furniture and its new sister corporation never were able to recover from the disastrous foray into retail. Indeed, the competition in AB's western Chinese market had grown extremely fierce. New local entrants, often based in cheaper locales surrounding D city with a large rural labor pool, as well as Guangdong companies, which could benefit from better transportation networks, created enormous competitive pressures. AB still possessed the advantage of a well-recognized brand name in D city, and its design and product quality tended to meet the demands of buyers. However, its once dominant position had vanished for good.

Mr. P brought AB Furniture back from the brink of bankruptcy, but his lofty vision of building a new company into western China's technology leader in furniture design had not come to fruition. Faced with limited opportunities for substantial growth (as Mr. P saw it), he stepped down from his management position in 2006 together with his friend, Mr. C. Although Mr. P and Mr. C still act as consultants to AB Furniture, their ownership stake in the new company was bought out by AB. AB thus reverted back to a family-based management system with Ms. A in the lead. It is now a medium-sized furniture manufacturer located at the outskirts of D city, profiting from its once dominant name recognition.

### *The Political Guanxi Networks of Ms. A*

So far this account of AB's rise, fall, and renewal reads like an illustrative case of the ups and downs of a family-run business. As in Taiwan, many family firms in China are expanding their tight family network to include new managers and stakeholders after experiencing problems. These new stakeholders can include distant family members, acquaintances, and old classmates, giving rise to the term "*guanxi* ownership" (Hamilton 1997). AB's story further expresses the importance of changing market conditions, and the need for businesses to employ effective investment strategies and human resource management systems. But perhaps most importantly, AB's evolution illustrates the crucial role played by an intangible asset: the political *guanxi* networks nurtured by Ms. A.

Due to her family background, Ms. A was invited to become a member of one of China's eight democratic parties in the early 1980s. These parties remain subservient to the CCP and are generally represented in the People's Consultative Conferences (PCCs) on various jurisdictional levels. Within the PCCs the eight democratic parties tend to act in an advisory function to the CCP leadership. They have also served as avenues for private entrepreneurs and various professionals to enter China's political sphere during the reform period.

According to Ms. A, it was not her membership in one of China's eight democratic parties that allowed her political career to take off. Rather, the rapid growth of AB Furniture in the late 1980s endeared her to top government officials in the township where AB was located. Therefore, starting with strong political contacts at the local level, Ms. A became a representative in D city's PCC and a member of one of D city's district-level People's Congresses in 1993.

In 1996 Ms. A moved up a further step and became a representative in the D City People's Congress. Finally, in 1998 Ms. A was invited to serve on the D City Quality Inspection Association. While the Quality Inspection Association is in principal non-governmental, it is closely associated with the D City Quality Inspection Department. The Association fulfills chiefly two functions. On one hand, it represents manufactures' interests and forms a bridge between government and industry. On the other, it is the main institutional conduit through which the Quality Inspection Department implements its policies.

According to Ms. A, she has not used her political positions to directly benefit AB Furniture. Naturally, as a People's Congress representative, Ms. A can call for certain issues to be considered (*ti'an*). However, all of her initiatives have focused on social issues without any direct bearing on AB's business. Ms. A also possesses a "green pass" which gives her direct access to the mayor of D city.

Despite Ms. A's refusal to acknowledge direct links between AB Furniture's development and her political activities, interviews with other stakeholders in AB Furniture made clear that the company was able to benefit in important ways from Ms. A's political positions. Since Ms. A is the corporation's principal external representative, her political standing has yielded a standing in China's political system for AB Furniture. AB thus enjoys greater respect from government officials and the bureaucracy works faster, better, and with less trouble. For instance, as AB Furniture moved into a temporary factory premise in early 2002 (after selling the old one) local village officials descended

on it to demand payments of all kinds. Due to her political *guanxi*, Ms. A could immediately contact the party secretary of the township within which the village is located. The troubles disappeared.

Specifically, AB Furniture has benefited in the following rather direct ways from Ms. A's political *guanxi* networks. First, the granting of official awards, such as the "famous brand name" award on the provincial level, has generated free advertising and public relations for AB Furniture.<sup>8</sup> While the first of these awards was handed to AB in 1988, the granting of subsequent awards all coincided with Ms. A's political ascent. The provincial "famous brand name" award was granted to AB several times between 1997 and 2006. In 2001 AB was also given the "Outstanding Enterprise" (*teji qiye*) award by the D City Quality Inspection Department.

Second, Ms. A's political status has made it easier for AB to access credit, especially in the early 1990s as it was very difficult for privately run enterprises (including "fake collectives") to take out big loans. Third, Ms. A's political stature facilitated access to crucial market information. Mr. P implied that AB knew at an early stage about plans to build a large shopping mall at the location of its factory premises. AB was thus able to move strategically to demand a good price for the sale of its premises. Indeed, by selling these factory premises at a good price, AB could stave off bankruptcy.

Finally, Ms. A's position on the D City Quality Inspection Association gives her indirect influence over the implementation of government policies in the furniture sector. For instance, Chinese local governments tend to initiate various policies to help promising private firms grow and upgrade their technology, including support for mergers and acquisitions of smaller competitors. These policies tend to be disseminated and carried out through industry associations and quality inspection associations.

In sum, AB Furniture's successes and failures can be traced back to market conditions, business strategies, and management quality. However, it can be hardly denied that Ms. A's political career did not generate key benefits for AB. Ms. A's political stature has allowed AB to gain better access to credit and government information. It also eased AB's dealings with government officials and opened the door to government sponsored awards and policy benefits. The advantages generated by political *guanxi* networks should thus be considered an important factor in underpinning AB's survival.

### **The Cases: The L Pharmaceutical Corporation**

L Pharmaceuticals was established in 1996 as a limited liability corporation with private ownership. Mr. L was the principal investor with 98 percent of the shares. In his 50s, Mr. L comes from a family of Chinese doctors. Although he only graduated from junior high school, he had stints in real estate and later as the vice-general manager of one of the largest and most famous Chinese Medicinal Corporations, W Corporation, in western China. In fact, the reason for establishing L Pharmaceutical was that Mr. L had a major difference of opinion with the boss of W Corporation over his share of profit in a project he had developed.

As a result of this altercation, Mr. L left W Corporation and established L Pharmaceutical with two partners. These two partners each own one percent of the shares of L Pharmaceutical. Both are in their 30s, worked at W Corporation with Mr. L, and come from the same hometown as Mr. L, P City. They, however, have no blood relations with Mr. L. One of them holds a degree in Chinese pharmacology and the other a degree in management. As L Pharmaceutical was established, Mr. L and his two partners put up 70 percent of the initial investment, while 30 percent came from bank loans. Mr. L had the financial means to establish L Pharmaceutical because he already had made money during his days in real estate. He was also able to cultivate excellent relations with banks during this time.

To begin with Mr. L rented factory facilities in P City, but then was able to buy 160 mou of land in 2000. On 60 mou of the land modern factory facilities were built, while the remaining 100 mou are reserved for a future investment in a Chinese medicinal herb plantation. In the early 2000s L Pharmaceutical was in a strongly developmental phase. Outlays often outstripped revenues, as in 2003 when the company's sales revenue stood at 44.3 million RMB and total outlays at 45.8 million RMB. Therefore, bank loans continuously increased, pushing L Pharmaceutical's debt/asset ratio from 30 percent in 1996 to 70 percent in 2003. The higher debt/asset ratio has made it difficult to receive additional loans from the banks. In fact, Mr. L noted that one of the greatest difficulties facing L Pharmaceutical was raising funds for production expansion, research and development, as well as for the Chinese medicinal herb plantation. L Pharmaceutical also faced problems in generating sufficient working capital. Nonetheless, L Pharmaceutical did not take on any new investors, rather relying on retained profits and bank loans for its working and investment capital needs.

L Pharmaceutical has over 600 employees, of which 200 are in production and 300 in sales. The company's products are primarily sold within China to pharmacies and hospitals. To retain close relations with customers L Pharmaceutical has about 60 sales outlets throughout China. All of these outlets receive no investment from L Pharmaceutical, although sales personnel generally are dispatched from L Pharmaceutical in P city. Sales executives raise their own working capital and receive a percentage of sales as commission. In production most employees are contract hires in their twenties with average yearly wages reaching more than 8,000 RMB.

L Pharmaceutical is registered as a limited liability corporation. Mr. L is the chair of the Board of Directors, while his two partners serve as directors. The board and management team are basically fused into one body. There are no government officials on L Pharmaceutical's board and there is no board of supervisors as stipulated in China's Company Law. Since there are party members within the corporation, L Pharmaceutical has established a party committee. One of the two partners acts as the party secretary. Unlike in state firms, though, the committee has no real power within the corporation. It purely takes care of party matters affecting party members working within the corporation.

L Pharmaceutical keeps very close relations with several government departments. Its "sectoral supervisory agency" is the D City Chemical Industry Department (D City is on a higher bureaucratic level than P City).<sup>9</sup> L Pharmaceutical has to pay what Mr. L termed a "management fee" to the Chemical Industry Department. In return L Pharmaceutical receives guidance on quality control, sectoral policies, and access to low

interest loans that the central Chinese government gives preferentially for technology improvements. The “supervisory agency” also assists L Pharmaceutical in dealing with other government departments, including Public Security, Health, and Labor. Even more important is that L Pharmaceutical is the largest taxpayer in P City. The firm therefore gets special treatment from the city, especially aid in gaining access to bank loans, land, licenses, etc.

Government support has aided L Pharmaceutical’s push to invest heavily in research and development. By employing several famous pharmacology experts, L Pharmaceutical has developed numerous new medicines, while others are about to move to production or are in testing stages. Indeed, L Pharmaceutical has established close relations with research departments under the D City Chemical Industry Bureau and with various universities. Beyond its home province, L Pharmaceutical has formed a technical partnership with the Pharmaceutical Research Institute of a major city along China’s eastern seaboard and a production joint venture in Vietnam.

As in the case of AB Furniture, close working relations with government agencies and affiliated units can be traced back to Mr. L’s political *guanxi* network. Naturally, the size of L Pharmaceutical in P City facilitates its access to government officials. It is widely understood that the successful tenure of any city mayor or party secretary is dependent on producing economic growth and government revenue. Government leaders therefore always try to support their biggest taxpayers. However, Mr. L himself has also cultivated an extensive *guanxi* network in his hometown. He is a member of P City’s PCC. In this capacity he can make his views known to officials, many of which take them seriously. The PCC is also an ideal venue to meet the city’s elite. In addition, Mr. L is the chair of the local county Chamber of Commerce and a standing member of P City’s All-China Federation of Industry and Commerce.

Mr. L combines a background in various business ventures, including pharmaceuticals, with a keen managerial acumen. Indeed, L Pharmaceutical comes across as an extremely well run corporation. However, as with Ms. A from AB Furniture, Mr. L has combined his experience and skills with the nurturing of strong political *guanxi* networks. This network is based on a combination of formal positions (especially on the P City Political Consultative Conference) and informal ties that have sprung from Mr. L’s family background in P City.

### **The Cases: The H Real Estate Corporation**

The political *guanxi* networks of Ms. A and Mr. L originate at least in part from official positions in China’s political establishment. They are based on institutionalized access to China’s political sphere, a somewhat exceptional situation in China. In fact, most private firms in China employ political *guanxi* networks that are of a highly informal and murky nature. To illustrate this situation we analyze a company active in the real estate sector, H Real Estate. The real estate sector is of special interest since access to land and capital can make or break a company in this sector. Political *guanxi* networks take on added importance.

H Real Estate Corporation was established by Mr. H in 1996.<sup>10</sup> Prior to this, Mr. H worked in the provincial party secretariat, the province’s highest political office. He

left his political post in 1992 and then worked as a general manager in the D city office of a large Hong Kong real estate developer. Mr. H thus combines work experience in a foreign invested corporation with a strong political background.

After various government policy pronouncements supporting the rapid development of China's real estate sector and a more tolerant environment for private businesses, Mr. H decided in 1996 to establish his own company. H Real Estate was formed as a limited liability corporation with 8 million RMB in registered capital and three shareholders. According to Mr. H all of the money invested in the corporation came out of his savings. However, this does not mean that Mr. H invested 8 million RMB in H Real Estate. It is common practice in China to borrow large sums of money on a short-term basis to register a corporation with a higher capital base. Most companies in China do this to give the impression of dependability and market power to government officials and state banks. Especially in the real estate sector a high registered capital base is crucial for clinging land deals.

H Real Estate from its establishment until the present had only three directors – Mr. H and two distant relatives. While the two relatives each own ten percent of H Real Estate and are entitled to dividend payments, they do not actively participate in management. All strategic and managerial decisions are concentrated in Mr. H's hands. Indeed, he both acts as chair of the board of directors and general manager. Due to his former political position, Mr. H is a member of the CCP. However, H Real Estate has no party committee and no direct formal links to CCP offices.

In D City, H Real Estate is considered a real estate firm with level three technologies. This means it can undertake high-rise projects, but is excluded from more technology intensive projects (e.g., difficult retail/residential projects; projects involving complex infrastructure). The management system of H Real Estate is closely modeled on the management of Hong Kong real estate developers. Indeed, Mr. H recruited most of the 12 employees of H Real Estate from his former employer, the Hong Kong real estate company. Some also are friends whom Mr. H met during business deals.

H Real Estate has mainly relied on retained profits to grow its business. In some instances, Mr. H has used his *guanxi* network to obtain short-term loans from individuals to bridge cash flow problems. Moreover, H Real Estate has worked hard to establish close relations with several banks. Only a few small loans for working capital have been taken out, but the company is aiming to gain access to bigger loans by cooperating with larger real estate developers.

Overall, H Real Estate is considered a medium-sized business in D city's real estate sector. There are about a dozen companies of H's size in D city, creating strong competitive pressures. Accordingly, Mr. H's strategy has been to seek out larger real estate developers and enter into cooperative ventures with them. One of H's recent forays is illustrative of this.

In 2001 the D City Party Committee and Government decided to develop the eastern district of the city, an area that contains many old state firms and had become run down during the reform period. Mr. H had no direct input into the drafting of the redevelopment project's policies. However, he knew early on about the scope and nature of the project due to his contacts in the government. Mr. H also knew that his corporation, faced with competition from many of D city's larger real estate corporations, would be too small to bid for projects on its own. He thus linked up with a larger real



estate corporation that possessed an important advantage when bidding for projects – its special *guanxi* with a factory that occupied a large tract of land slated for redevelopment.

Mr. H's motivation for entering this partnership is clear. H Real Estate needed a larger partner with direct access to land to remain competitive. However, why would the larger real estate corporation require a smaller partner in this venture? According to an academic familiar with Mr. H, H Real Estate's valuable political *guanxi* networks made it a desirable partner. Many of Mr. H's subordinates and superiors from his years in the provincial party secretariat moved on to more important positions. One of them, for example, became the vice-party secretary of an important district of D City, while others served as the secretaries of top provincial leaders. Mr. H thus possesses a wide-ranging political *guanxi* network at a high level, extremely important in smoothing relations with various government departments in bidding for and developing real estate projects. In addition, H Real Estate employed in 2001 as vice-general manager another important link into the political sphere, the son of a provincial vice-party secretary.

The importance of political *guanxi* networks in general is reflected in Mr. H's comments on the two factors which facilitated H Real Estate's development. First, Mr. H feels that the quality of the entrepreneur is key in a firm's success. As he puts it: "If the entrepreneur is able he/she will succeed even without capital; if he/she is incapable, even a lot of capital won't help." Second, Mr. H notes that *guanxi* networks were a decisive factor in H Real Estate's business success. On the one hand, close family and personal *guanxi* networks allowed H Real Estate to surmount many initial problems. Family and close friends were willing to work without salary and benefits for months, in some cases even putting up money to prevent cash flow problems. On the other hand, broad political *guanxi* networks must be viewed as a key element in the success of a real estate developer. As Mr. H argues: "*Guanxi* are more important than capital. If you have *guanxi*, you will have access to capital. However, if an entrepreneur has capital but no *guanxi*, his/her business cannot survive."

Above all, political *guanxi* networks are important because real estate developers need to deal with a comparatively large number of government agencies, each of which can block or hold up a real estate development. These include the Construction Commission, the Industrial and Commercial Bureau, the State Land Bureau, the Planning Commission, the Environmental Protection Agency, the Zoning Department, and the Public Security and Fire Department. Perhaps most important is dealing with local government leaders and the leaders of specially designated redevelopment departments, which carry the overall responsibility for planning and implementing the redevelopment of certain city districts. These key individuals have important decision-making authority on land sales and the granting of development rights.

The importance of political *guanxi* networks is expressed by the fact that Mr. H spends about 50 percent of his time cultivating these networks and dealing with various government departments and officials. In this respect, Mr. H notes that he possesses especially close and good relations with the agency "supervising" real estate developers, the D City Construction Commission. Mr. H's political *guanxi* networks also allow him to keep good relations with government officials when problems are encountered. Problems include various demands from government agencies and officials for fees, in-kind benefits (use of cars, phones, materials, etc.) and cash. As Mr. H put it: "There is no use in resisting, because if you do you will just get into deeper trouble."

Perhaps most important from H Real Estate's point of view is the continued discrimination against private corporations in the real estate sector.<sup>11</sup> According to Mr. H there is no way that private corporations can enjoy the same policy benefits as state-owned real estate developers. Private corporations suffer since it is up to local governments to decide how to implement central policies, thus creating a conflict of interest that prods local governments to support the real estate developers they own or are linked to. For instance, the State Land Bureau allows state enterprises to pay for land acquisition costs in installments, but rarely does so for private enterprises. Private enterprises also need to show that they have sufficient collateral for taking out large loans from state banks, a condition seldom applied to state firms.

Besides a highly flexible management system and a healthy business strategy, Mr. H notes that political *guanxi* networks have given his corporation a distinct competitive advantage. This advantage is amplified since most of D city's smaller real estate companies are managed by entrepreneurs with a rural background. These farmers-turned-entrepreneurs can hardly muster the same political *guanxi* networks as Mr. H, especially on the provincial level. Mr. H thus feels highly confident about H Real Estate's future.

### **Concluding Remarks**

The three case studies presented provide a snapshot of how private businesses relate to China's political sphere. They illustrate the importance and differing nature of political *guanxi* networks found in China's private sector. More generally, our complete sample of 15 private corporations shows that political *guanxi* networks are significant in most Chinese business ventures, albeit with considerable variations. These variations can be conceived as existing along three main axes: the sectoral location of a firm; the size of its business; and the type of political *guanxi* networks managers decide or have the opportunity to nurture.

First, there are considerable variations across sectors. Political networks are clearly a key factor influencing the business prospects of real estate developers. Developers are dependent on access to land and capital, both of which tend to be closely controlled by local government agencies. In contrast, the picture is quite varied among the high-tech and manufacturing enterprises interviewed. For some manufacturers producing mass-consumption goods, political *guanxi* networks are of only minor importance. However, in sectors with continued intensive government involvement, such as printing or wine, political networks are perceived to be crucial. Several enterprises also noted that once they planned on selling their products in a new geographical area, they first needed to establish political networks with government officials in that locality. Quite logically, we found from our limited sample of 15 corporations that sectoral variation depends mainly on the extent to which government officials control key inputs, markets, and the regulatory framework in each sector. Nonetheless, all interviewees noted that as a private firm grows in size, political *guanxi* networks increase in importance.

Firm size therefore plays a central role in the significance of political *guanxi* networks (see also Wank 1999). For instance, the two managers of a small textile firm noted that they saw limited use in establishing political *guanxi* networks. The firm was in

its entrepreneurial phase and mainly concerned with growing its business from a small base.

The case of AB Furniture, though, is particularly illustrative in this respect. At first AB Furniture only needed to create good political *guanxi* networks with village and township officials, since these could directly influence AB's operations. However, as AB's business grew, it could benefit from political *guanxi* networks established at higher levels. Indeed, AB's growth trajectory and Ms. A's political career have run roughly parallel to each other. A similar pattern can be discerned in L Pharmaceutical's case and others. For instance, one real estate corporation interviewed first established political *guanxi* networks at the district level. As its business grew it nurtured networks at the city level, and finally started to form political networks at the central level to gain access to large amounts of capital and expand into other cities.

In sum, political *guanxi* networks in China's private sector seem to increase in importance as a firm's size increases. Moreover, as size increases political *guanxi* networks graduate from the local political level to the city, provincial and, finally, central level. Political *guanxi* networks climb China's political hierarchy as a firm's size and market reach go national.

A final variation concerns the types of political *guanxi* networks nurtured by firm managers. Our sample of 15 firms generates roughly two types. Low levels of transparency and informal interactions characterize the first type, which is nicely illustrated by the case of H Real Estate. Often these networks are created by the fact that the entrepreneur formerly held political positions. Especially in TVEs that have been privatized former government leaders tend to become owners or top managers, thus creating direct links to the local political establishment.

The second type is represented by the case of AB Furniture and L Pharmaceuticals. These political *guanxi* networks are somewhat more institutionalized. Top enterprise leaders hold formal political positions, often by acting as representatives in the People's Congress' or the People's Consultative Conferences. Formal links to the political sphere are also established by taking part in the activities of trade associations and government advisory committees. However, it should be noted that although these networks are based on the formal political positions of enterprise leaders, the actual formation of *guanxi* networks happens in informal and fluid ways. As Mr. L of L Pharmaceuticals puts it: "My official political position gives me ample opportunity to establish *guanxi* networks with a wide range of government and party officials. It is like belonging to a club."

As in all instances of initial capitalist accumulation, private firms in China faced during the first decades of reform government predation, ambiguous and fluid institutions, and access barriers to markets. However, many local government officials in China faced early on incentives to maximize economic output, and thus warmed to the dynamism of local private firms. This is in stark contrast to Russia, where government predation was highly accentuated during the transition (see Frye and Shleifer 1997).

Even more importantly, in contrast to Russia's reform experiences, the evolution of more symbiotic government-private sector ties in China was supported by a strong affinity for strong *guanxi* networks. The existence of these networks complemented the development of markets and institutions and can be traced back to the nature of Chinese capitalism. As Yang (2002: 467) notes: "Chinese capitalism is shown to differ from

Western capitalism in that it emerges from a Chinese cultural tradition of small family firms based on paternal authority and personal trust rather than a legal system, and the importance of interpersonal and kinship relations rather than individual rights.”

*Guanxi* networks have therefore become a force for economic development in China, helping the country to overcome a lack of institutional infrastructure and destructive abuses of government power. It is, though, important to note that *guanxi* networks springing from Chinese cultural roots tend to benefit those with close ties into China’s political sphere most. As the cases presented here illustrate, those connected to political power find it easier to establish and grow private ventures (see also Meng 2003: 317). Nurturing a political *guanxi* network is therefore an important ingredient in firm success. Political *guanxi* networks can generate avenues to access information on government policies and plans, produce opportunities for new ventures, aid in the process of conflict resolution, and create lucrative returns (see Wang 2001).

The significance of political *guanxi* networks in China’s private sector does not imply that the nature and logic of these networks is immutable. As China’s economy develops, many of the present restrictions on the private sector are likely to be lifted. On one hand, the institutionalization of legal and economic rules is proceeding apace in China, increasing the importance of legal standards and contractual obligations. On the other, private capital in China is becoming more mobile, changing the nature of locally embedded *guanxi* networks (Hendrischke 2004).

Therefore, as the conditions of China’s private sector change, the nature of political *guanxi* networks is liable to change too. For example, one reason prodding real estate developers to emphasize political *guanxi* networks is the murky manner in which local Chinese governments grant development rights and sell land. However, there is central pressure for Chinese local governments to move towards a more open and transparent land tendering system. This will change the dynamics of interaction among private developers and government agencies.

In a related vein, the CCP’s decision on allowing private entrepreneurs to join is liable to foster the development of political *guanxi* networks similar to those nurtured by Ms. A and Mr. L. These networks are liable to rely on private entrepreneurs taking up party membership and/or official political positions. As a consequence, the importance of highly murky and informal political *guanxi* networks might moderate somewhat and give way to more institutionalized channels of networking. Similarly, the need for political *guanxi* networks at the local level might diminish as local government control over economic resources weakens.

Nonetheless, as in most instances of initial capitalist accumulation, the influence of government is likely to remain large in China. Therefore, political *guanxi* networks will be of continued significance in China’s private sector. In fact, *guanxi* networks will continue to penetrate business-industrial activities, meld with the institutionalization of formal rules and regulations, and lend China’s emerging capitalism its unique characteristics.

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## ENDNOTES

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<sup>1</sup> *Guanxi* is often translated as “connections” or “membership,” though these English terms hardly capture the depth of *guanxi* relations. *Guanxi* denotes the establishment of long-term informal reciprocal personal relationships. It is a form of social capital that acts as a binding agent among social actors. *Guanxi* ties can therefore create enduring trust which facilitates business dealings and collaborative ties among firms.

<sup>2</sup> Arguments on the decline of *guanxi* in China dovetail with the convergence perspective. The convergence perspective holds that as developing countries liberalize markets, develop institutions and adopt modern technologies, their institutions will *converge* with those of Western advanced industrial nations based on legal-rational principles of organization (see Useem 1996).

<sup>3</sup> Our argument thus takes an “interactionist” (Zhu 2000) or “crossvergence” (Ralston *et al* 1993) perspective on the evolution of capitalist institutions in China. Hybrid institutional arrangements expressing values set in between Western and Chinese value systems are liable to emerge.

<sup>4</sup> Different accounts stress different divisions among the development phases of China’s private sector, although all agree that there have been roughly three phases. See International Finance Corporation (2000), Young (1995), and So (2000).

<sup>5</sup> TVEs are collectives owned by local governments and represent a uniquely Chinese form of local government ownership.

<sup>6</sup> All of the enterprises interviewed are registered as limited liability corporations, except one enterprise that is registered as a state-owned enterprise (SOE). However, in this SOE an individual or group of individuals had to take risk, was able to claim residual profit, and had the ability to allocate or transfer the firm’s assets.

<sup>7</sup> To protect the identities of interviewees different names and abbreviations are used. The materials on the AB corporation were obtained by conducting several interviews: with the owners Mr. A and Ms. A; with the General Manager, Mr. P; and with the Factory Manager, Mr. C. The interviews were conducted over the period of 2001 - 2007.

<sup>8</sup> Interviewees noted that these awards generally go to firms that government officials want to make into local, provincial, or national champions. Market competitiveness therefore does not necessarily influence which companies receive these awards.

<sup>9</sup> It is interesting to note that several of the private enterprises interviewed, including AB Furniture, mentioned that they had a “zhuguan bumen” (supervisory agency), a term borrowed from China’s state sector in which government departments directly supervise and manage enterprises. In some cases, the “zhuguan bumen” referred to is a Chinese sectoral trade association; in other cases (as with L Pharmaceutical) it is an actual government agency.

<sup>10</sup> The materials on H Real Estate corporation were obtained by conducting interviews with Mr. H, the chair of board of directors and general manager; with Mr. T, a vice-general manager; and with an academic closely familiar with China’s real estate market and H Real Estate’s business conditions. The interviews were conducted between 2001 and 2007.

<sup>11</sup> Interestingly, another real estate corporation interviewed in our sample had deliberately registered as a state-owned entity to avoid discrimination. The company, though, was managed exclusively by two partners and had no state investment.