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Work and Organizations in China after Thirty Years of Transition

Lisa Keister
Editor

WORK AND ORGANIZATIONS IN CHINA AFTER THIRTY YEARS OF TRANSITION

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WORK AND ORGANIZATIONS IN CHINA AFTER THIRTY YEARS OF TRANSITION

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INVESTOR IN PEOPLE

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INTRODUCTION

Thirty years of rapid development and economic change have created organizations and work relations in China that would have been unthinkable at the start of transition. In December of 1978, the Chinese Communist Party agreed with Deng Xiaoping to allow agricultural privatization, a stark contrast to the communes of Mao Zedong's era. This change established the financial foundation that would lead to development in eastern, coastal cities and that would ultimately fuel an extraordinary transformation of China's economy and its global position. As a result, organizational structures have changed, and new organizational forms have emerged. There have also been dramatic changes in the way work organizations behave and in the nature and implications of work. This volume provides a glimpse into the state of organizations and work at the 30-year mark. The contributors are top scholars in the field, including many who have observed and studied China's transition for decades, who are drawing on some of the most up-to-date and innovative data sources available. The chapters are samples of the current work of these researchers that, taken together, provide a snapshot of the state of research on China's organizations and work behaviors as transition enters its fourth decade.

Part I addresses the nature and behavior of organizations. Victor Nee and Sonja Opper extend market transition theory, Nee's theory that initiated a great deal of current debate about stratification outcomes during transition, to a firm-level analysis. Nee and Opper identify the advantages of broadening the theory's scope to include organizations, extend the theory's hypotheses to firms, and provide preliminary empirical evaluation of their claims. The remaining papers in this section identify and study important changes in particular organizations and types of organizations, starting with a pair of papers that address emerging economic institutions. Doug Guthrie, Zhixing Xiao, and Junmin Wang start the section by exploring the transformation of state offices from governing bodies to asset management companies. Their use of quantitative and case study data allows them to draw general conclusions about the implications of structural change for firms while providing insight into the mechanisms by which this movement occurs. Ling Yang and Xueguang Zhou provide insight into the emergence

of another economic institution: interfirm contracts. Specifically, they examine contract duration and provide evidence from more than 800 contracts from 620 firms.

The following three papers address unique innovations and their impact on three types of organizations. Yusheng Peng addresses the impact of inward foreign direct investment (FDI) on the productivity of state-owned enterprises (SOES). Peng shows that the presence of FDI-related firms improves total factor productivity of SOEs located in the same city but not associated with the FDI. He concludes that his results are not simply technology spillovers but rather FDI-induced change. Keister and Hodson also study SOEs, but they use a different data source to study the effect of ownership type (SOE compared to collective enterprises and other nonstate firms) on the adoption of four innovations. Cao and Zhao move beyond SOEs to study labor management structures in China's foreign-invested enterprises (FIEs). They investigate the adoption of two Chinese-style and two Western-style labor structures. They provide evidence that the two Chinese-style structures reduce tension and conflict between labor and management, but the two Western-style structures have little of this effect. They use their findings to highlight the power of the Chinese institutional environment and to discuss how organizational interest interacts with institutional forces.

The final two papers in Part I both discuss linkeages between organizations and work, providing a transition to the second part of this volume. Mike Peng and Martina Quan deal explicitly with micro–macro links. They point out that the relationship between micro (e.g., interpersonal connections) and macro (e.g., interorganizational relationships, firm strategies, performance) is an important theme in research on management and organizations in China. They review related papers from leading journals and propose ideas for understanding how the network structure of managerial connections will develop in different phases of China's transition. Peng and Quan conclude with a call for future research to make this relationship more central. Lin, Zhang, Chen, Ao, and Song do not conceptualize their work as a micro–macro link, but their approach is quite similar to that of Peng and Quan. Lin et al. study the recruiting and deploying of social capital to organizations. They start with the observation that social capital operates at both the macro (organization) and micro (individual) levels. They develop a pair of intriguing hypotheses to explain why and how organizations recruit and deploy social capital.

The papers in Part II of this volume address issues related to work and work relations. Yanjie Bian and Xianbi Huang start the section with an

exploration of how network resources affect job mobility. They draw on data from a five-city survey to study how social ties affect job change, search time, and job–worker matching. They show that those who change jobs who use information and influence networks increase both search time and job–worker matching, whereas those using only influence networks improve earning opportunities. The next four papers each address work and inequality in some fashion. The first two papers address the continuing role of the *danwei* (the work unit) in producing and maintaining inequality, and the second two explore the mechanisms that generate particular types of inequality. First, Yu Xie, Qing Lai, and Xiaogang Wu propose that the danwei continues to be an important source of stratification in contemporary China. They draw on data from three large cities to show that earnings and benefits are still related to characteristics of the work unit in ways that are similar to pre-reform patterns. In the next paper, Dorothy Solinger explores the fate of those who no longer have a connection to a danwei. She studies people who lost their jobs and those who ultimately became destitute after losing positions at a danwei. She draws on her in-depth research on China's economy and labor practices to describe and evaluate contemporary labor policies and the fate of workers who are at the mercy of these policies.

The next pair of papers provides insight into specific types of work-related inequality. Michelson notes that gender inequality has become more extreme in many occupations in China, and he sets out to uncover whether the same is true in the legal profession. He uses four sources of quantitative data to document that gender inequality in law mirrors patterns in other professions. His findings demonstrate that women are, indeed, enjoying more opportunities in law, but he shows that women still earn less income and are less likely to become law firm partners, two important indicators of job quality. C. Cindy Fan also addresses gender inequality, but her conclusions about male–female differences are part of a larger study of labor migration and household work. Fan studies work flexibility among rural migrants and the implications of this flexibility for household organization. She argues that migrants' work flexibility necessitates flexibility at home, between genders and across generations. Her conclusions about the implications of migration patterns for the household division of labor provide unique insights into two distinct literatures as well as for the future of social and economic stratification in China.

The final paper in the volume addresses the important linkage between politics and economics. Bai Gao starts by noting that observers of China can be surprised by the coexistence of an economy known for expanding trade and global production and an authoritarian political system that has

escaped a global movement toward democratization. Gao reviews the literature on China's prospects for democratization, and he argues that other observers have overlooked important strategic responses by China's party state. He also contends that other researchers need to move beyond reliance on a simple conceptualization of the state as authoritarian or democratic and to incorporate the varied state responses in their conceptualization and analysis. Gao identifies six distinct sides (or faces) the China's party state assumes, including authoritarian, neoliberal, developmental, predatory, refined socialist, and corporatist. He concludes that the coexistence of these six personae has allowed China to become a powerful economic entity while preventing it from moving toward democratization.

In conclusion, I would like to acknowledge the organizations and people who contributed to the production of this volume. The Duke University Department of Sociology provided resources, and Zoe Morris and Claire Ferres of Emerald provided production and editorial support. Most of all, Yanlong Zhang provided excellent administrative and research support throughout the compilation of this volume.

PART I
ORGANIZATIONS

BRINGING MARKET TRANSITION THEORY TO THE FIRM

Victor Nee and Sonja Opper

1. INTRODUCTION

Market transition theory has specified general mechanisms to explain change in the balance of power between political and economic actors in transition economies. These mechanisms drive the endogenous construction of informal institutions of a market society; moreover, it is within the context of an ongoing change in relative power that the formal institutions of the emerging market economy arise. The theory makes clear predictions on the declining value of political capital as a consequence of progressive *marketization*, which incrementally results in transformative change in the direction of more relative autonomy between the political and economic spheres, not dissimilar from established market economies (Kornai, 1995; Evans, 1995; Nee, 2000; Lindenberg, 2000; Ricketts, 2000). In sum, the predicted change in relative power between redistributors and producers explains not only bottom-up entrepreneurial activity, but also the emergence of a market economy in departures from state socialism.

Although the evolving market transition debate has been fruitful in stimulating a robust research program in sociology and economics with over 25 empirical research reports published in peer-reviewed journals in sociology and economics (see Appendix A; King & Szélenyi, 2005; Keister, 2009; Keister, forthcoming), the potential of the theory is far from exploited.

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While the theory in its original formulation (Nee, 1989) sought to explain dynamic power shifts from redistributors to producers as a consequence of marketization, the emerging research program, however, almost exclusively followed the first set of derived hypotheses and its focus on determinants of household income.

Subsequent research employed readily comparable ordinary least squares (OLS) models – the standard human capital model of income determination (Mincer, 1958, 1974) – adapted to include measures of political capital (Nee, 1989; Xie & Hannum, 1996). Empirical evidence, however, remained mixed and inconclusive and controversy over the fate of political capital in new market economies seems unresolved. This is reflected in the anomaly of a near even split between the articles reporting results consistent with the prediction of decline in value of political capital caused by competitive markets (Nee, 1989, 1991, 1996) and those that report the opposite (Walder, 1996, 2003; Parish & Michelson, 1996) or tender competitive hypotheses (Róna-Tas, 1994; Bian & Logan, 1996).

The aim of this paper is to revitalize the theory's original focus on dynamic power shifts between redistributors and producers by extending the theory's empirical application to a firm-level analysis. The firm as the ultimate generator of income provides the most direct approach to analyze the interplay between market power, political capital, and economic outcome. By contrasting firm-level transactions across institutional domains representing various levels of marketization and state control, it is possible to directly examine the effect of political capital on distinct economic outcomes. If observed political benefits are manifest predominantly in state-controlled institutional domains, this would support market transition theory predicting a direct link between marketization and the value of political capital. However, if political capital is just as fungible in marketized as it is in state-controlled domains, this would lead to a decisive rejection of the theory's claim. Instead, such a result would support the assertion of the theory's critic that markets have no causal significance in enabling, motivating, and guiding economic action (Walder, 1996).

The remainder of this essay proceeds as follows: First, we identify general advantages connected with a focus on firm-level studies and highlight some of the inherent problems of income attainment models. Section 3 then extends the original propositions of market transition theory to firm-level analysis. Section 4 provides some cursory evidence, and section 5 concludes. Overall, with descriptive and qualitative evidence, we show that the value of political capital is closely linked with the type of institutional domains in which agents use political connections to secure advantages.

2. FROM HOUSEHOLD TO FIRM-LEVEL ANALYSIS

To highlight general advantages of firm-level analysis for tests of market transition theory, it is useful to begin with a review of inherent problems of studies applying income attainment models. Oberschall (1996) raised early doubts about whether income and income inequality can "give us any clue about the shape of emerging institutions" (Oberschall, 1996). Similarly, Guthrie (1997) warned that income-related studies on elite change "show no direct or concrete evidence about the fate of the hierarchy of former command economies" and suggested instead a focus on firm-level studies (Guthrie, 1999). The problem is income attainment models cannot reveal whether economic advantages captured by politically connected households or individuals come from their ongoing exchange in political markets or from persisting advantages in competitive markets. Moreover, the reliability of household-level research hinges critically on the use of reliable proxies of marketization to control for the quality of the corresponding household environment.

We identify three measurement approaches widely used in the market transition literature: First, an intuitively convincing way to measure the extent of market allocation has built on the assumption that market exchange depends on the existence of private property rights (Kornai, 1990). A related approach to measurement has focused on the proportion of industrial output produced by private, collective, and state-owned enterprises (Nee, 1996, Nee & Cao, 1999); firm ownership (Parish, Zhe, & Li, 1995; Wu, 2002); the proportion of household income in nonagricultural production (Walder, 2002b); and the degree of privatization (Opper, Wong, & Hu, 2002). Second, time has repeatedly been used as a proxy for the duration of market transition. This approach assumes a linear progression in the development of a market economy, which may be true in the long term, but not necessarily in the shorter run. Moreover, the use of time as a proxy for marketization risks overlap with confounding causes such as regional business cycle, labor market fluctuations, capital investments, and locally restricted reform initiatives, which are difficult to control for due to severe data limitations at the local level. Finally, a whole host of other measures have been used, which measure concepts other than marketization. A number of tests of market transition theory relied on measures of economic growth (Xie & Hannum, 1996; Walder, 2002a, 2002b; Hauser & Xie, 2005) or structural change (Parish & Michelson, 1996; Walder & Zhao, 2006). Validity problems of these measures are palpable. Economic growth and structural change are macroeconomic performance measures, determined by

a complex set of factors including technology development, labor, and capital input, among which marketization may but need not play a decisive role.

Given so many different measurements of the same underlying concept, it is obvious that some will correlate only weakly with *market transition* defined as the ''decisiveness of the shift to reliance on the market mechanism in the allocation and distribution'' of goods and services (Nee, 1989, p. 667). An enormous variation in correlation coefficients between the different measures of the extent of marketization underlines the severity of the measurement issues. This is seen in using the standardized marketization index constructed by the National Economic Research Institute (NERI) (Fan & Wang, 2003) to calculate correlation coefficients with measures most commonly used in the market transition literature. Using provincial-level data covering the period from 1997 to 2003 (see Table 1), marketization measured as the proportion of non-state industrial production shows the highest correlation coefficient with the marketization index (0.81). Also comparatively high is the correlation coefficient of rural income (0.72), indicating a closer overlap with marketization. However, the lower correlation coefficient of 0.62 between rural income and proportion of non-state industrial production indicates that both proxies capture different concepts connected with marketization. All remaining measures are only weakly correlated. The use of GDP-growth measure seems particularly problematic. Though Hauser and Xie (2005) defend the use of GDP-based measures with reported close correlations between GDP and marketization (NERI), this is true only for absolute values but not for growth rates. Finally, passage of time captures marketization inadequately. With a correlation coefficient of 0.14, repeated surveys over relatively short periods of time are unlikely to properly signal the effects of market transition on predicted outcomes.

The consequences of the inconsistent and diverse measures of the key causal concept – marketization – are nontrivial. This is seen in the close correspondence between the choice of measurement and the validation of market transition theory (see Appendix A). Only one of the nine studies, which actually measures the extent and scope of marketization, rejects the hypothesis of decline in the value of political capital. On the other hand, out of 19 studies using the proxies of economic growth and structural measures or time or no measure of marketization, 16 studies reject the power-decline hypothesis. This yields an odds-ratio of 42.7, that is, the odds of confirmation are about 43 times higher when proxies of market transition are used instead of measures of structural change or development.

Table 1. Correlation Matrix of Provincial-Level Measures, 1997–2003 ($N = 230$).

Measure/Marketization Proxy	Studies	1	2	3	4	5	6	7	8
Marketization									
1 Marketization index	Li, Meng, and Zhang (2006)	1.00							
2 Non-state industrial production ratio	Nee (1996), Nee and Cao (1999)	0.81	1.00						
Economic structure									
3 Share of agricultural in GDP	Walder (2002b), Walder and Zhao, 2006	−0.03	−0.004	1.00					
4 Non-farm labor ratio	Parish and Michelson (1996)	0.14	0.02	−0.78	1.00				
Growth and development									
5 GDP growth/per capita GDP growth	Xie and Hannum (1996); Hauser and Xie (2005)	−0.12	0.13	0.02	0.01	1.00			
6 Per capita gross industrial output	Walder (2002a)	0.57	0.53	0.13	−0.11	0.20	1.00		
7 Rural income	Walder (2002b)	0.72	0.62	0.003	0.03	0.16	0.91	1.00	
Time									
8 Year	Nee (1989); Bian and Logan (1996), Zhou (2000); Murdoch and Sicular (2000); Choi and Zhou (2001)	0.14	0.08	−0.04	0.09	0.22	0.15	0.16	1.00

Sources: Provincial data from National Statistical Bureau of China, China State Statistical Yearbook, 1998–2004; marketization index from Fan and Wang (2003).

Inadvertently, a large proportion of the contributions to the market-transition controversy in fact tested alternative theories on the association between economic growth and structural changes and the value of political capital. The consistent finding of these studies (Xie & Hannum, 1996; Walder, 2002a, 2002b; Hauser & Xie, 2005; Parish & Michelson, 1996) is that *economic growth and structural change do not adversely affect the market value of political capital of the established elite*.

Our review underscores the need for more direct ways to study the connection between marketization and the value of political capital based on positional power in the government and communist party. We assert that a revitalization of the theory's original focus on producers provides an alternative approach to examine the association between market transition and the valuation of political capital. A firm-level analysis does not critically depend on the choice of proxies for marketization. We contend that in order to determine whether the prediction of a decline of political capital in price-making markets is accurate, empirical tests need to focus on discrete economic transactions linked to well-defined institutional domains of the transition economy. In this way it is possible to discern with greater reliability whether political capital loses its direct advantage in transactions in market exchange or, alternatively, maintains or possibly even gains advantage in such transactions. Clearly, this approach promises a more direct way to explore whether political connections really help managers and entrepreneurs "to get more out of their *effort* because of their power and connections" (Walder, 1996, p. 1067).

3. MARKET TRANSITION THEORY: THE PRODUCER PERSPECTIVE

In the early period of hypothesis testing, the original set of derived hypotheses and subsequent empirical applications focused on agricultural households as the new producer class of the 1980s. But following the expansion of producer activities beyond the agricultural sector, conditions of income generation in nonagricultural firms emerged as an important new application for empirical confirmation. We briefly reconcile market transition theory's three interrelated theses with the expansion of the scope of marketization beyond the agricultural sector, and derive testable hypothesis that allow a direct application to industrial and commercial enterprises.

The *market power thesis* asserts that replacement of state bureaucratic allocation by market allocation involves a shift of power favoring direct producers relative to redistributors. This assertion is enormously consequential for understanding change in the institutional environment of firms. Almost imperceptibly, but accelerating following tipping points, self-reinforcing shifts in the institutional environment cause traditional state-owned enterprises of the old redistributive economy to lose market share to hybrid and private ownership forms (Nee, 1992, 2005). Furthermore, increasing competition and dependence on market outcomes raises the costs of political interference (Boycko & Shleifer, 1993; Opper et al., 2002; Fan, Wong, & Zhang, 2007; Nee, Opper, & Wong, 2007). Concurrent with these trends, greater organizational autonomy embedded in decentralized markets enable economic actors to construct informal arrangements that build from ground-up the informal institutions of a private enterprise economy. From informal lending arrangements to provide private capital for start-up firms to far-flung supply and distribution networks, informal economic institutions emerged to facilitate the expansion of private sector entrepreneurial activities challenging the state-directed economy from below.

A direct extension of the market power thesis suggests that with marketization, the economic success of producers is increasingly independent of the involvement of redistributors. In a general formulation, firms will experience a decline in the value of their political connections. This, however, does not imply, as some have interpreted, a complete devaluation of political connections. After all, political capital is fungible in all types of economies, from transitional to mature market economies. In all market economies, political connections matter for firms lobbying to secure preferential treatment by government (Stigler, 1971; Krueger, 1974). It follows that in market economies, political capital, as a fungible form of capital, has greatest valuation in those institutional domains where government restricts economic activity. Analogous to the original derivation specifying income effects at the household level, we assert:

Hypothesis 1. The more market exchange replaces the redistributive mechanism, the less the value of political capital relative to capital stemming from the capabilities and market performance of the firm.

The *market incentive thesis* emphasizes changes in the structure of incentive stemming from market transition. With marketization, rewards are increasingly based on performance rather than the strength of political ties, which creates positive incentives for entrepreneurial activities and innovativeness. Further, as market competition intensifies, firms face

growing pressure to invest in capabilities in order to survive the withering competition. Whether entrepreneurial activity is for the sake of the fruits of success, or for success itself, in price-making markets rewards are based on the competitive sorting and matching of quality and price. It is thus the restoration of consumers' and producers' sovereignty in transition economies, which activates market incentives. The specification of the market incentive thesis is close to Baumol's (1990) supposition that the most effective way to stimulate productive entrepreneurial activity is to diminish relative rewards to unproductive or destructive rent seeking and increase payoffs to productive entrepreneurial activity. While Baumol's entrepreneurial theory is referring to within-system variation in market economies, the market incentive thesis emphasizes the transfer from a planned economy to a system primarily based on market exchange.

As a direct extension of the incentive thesis, capability development of firms should be correlated with the extent of marketization and interfirm competition. The most important entrepreneurial response to market incentives is through innovation. In increasingly competitive markets, firms have incentives to innovate to extend their profit margin or to come up with new products, which help to escape competitive pressure until imitators come up with similar product or production technologies. In general, we expect:

Hypothesis 2. The transition from state socialist redistribution to markets increases the value of a firm's capability development.

Finally, the *opportunity thesis* emphasizes the markets' crucial role in enabling entrepreneurial activities. The opportunity thesis goes beyond the idea of resource availability allocated through markets. The price-finding mechanism signals disequilibria of supply and demand, wherein high or increasing prices indicate demand and attract new producers to establish new or neglected lines of production. The market mechanism also offers economic actors a means to assess potential opportunities from entrepreneurial activities as well as opportunity costs for failing to invest in productive activities (Hayek, 1978). The emergence of markets thus endogenously expands the opportunities for entrepreneurs and firms to identify new markets and prospects for profit making. Given the central role of free markets for opportunity identification, we derive the following hypotheses:

Hypothesis 3. In transitions to a market economy, the development of free markets provides the opportunity structure for new market entry by direct producers.

4. EVIDENCE FROM A TRANSACTION-FOCUSED ANALYSIS

At the most cursory level, a focus on China's increasing diversity of organizational forms signals an ongoing devaluation of political capital. The graph in Fig. 1 uses nonagricultural employment data to illustrate the accelerating ownership diversification between 1990 and 2002. What is notable here is not only the rapid decline of the relative share of state-owned firms, but also the rapid growth of private ownership, both in the form of private or individual enterprises and also in the form of rural private and individual firms formally registered as township village enterprises.

Ownership diversification per se, however, may not yet indicate that political capital is truly devaluating. Political capital, independent of the ownership form, might still facilitate access to resources controlled by the state, or in the case of new organizational forms confer legitimacy. For example, the so-called "red hat" firms in the early reform period were predominately private firms in the guise of township and village enterprises owned by local government (Huang, 2008). Confirmation of Hypothesis 1 therefore hinges on a closer review of the relation between political capital and firm performance.

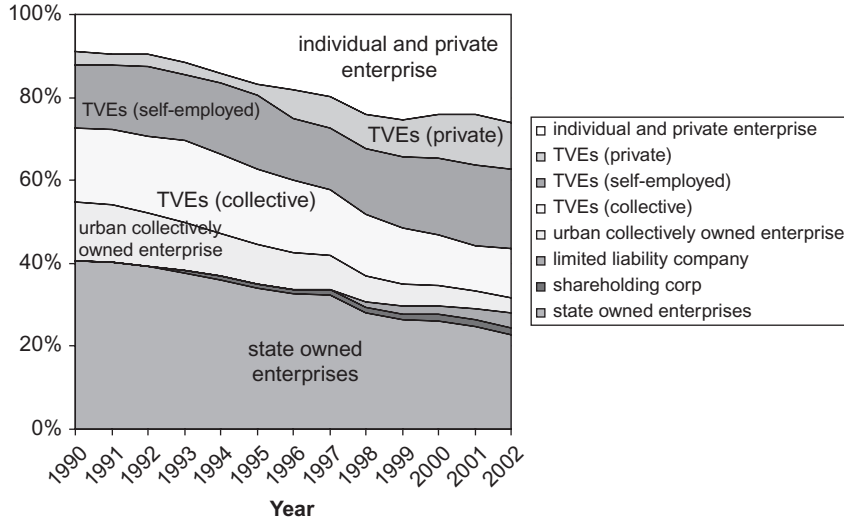

Fig. 1. Employment by Organizational Form. *Source*: National Bureau of Statistics of China (various years).

To reliably confirm a possible link between the value of political capital and marketization, we follow Nee's (1991, p. 279) assertion that the "value of personal connections with cadres is a function of the extent to which the allocation of resources … remains bounded by the redistributive economy." Because firms operate simultaneously in a great variety of institutional domains, we assert that a comparative analysis of regions or even industrial sectors would still leave a great leeway for potential ambiguity on the link between marketization and the fungibility of political forms of capital. Instead, we suggest a transaction-focused approach to study more directly the association between marketization and positional advantages stemming from political connections. Such approach acknowledges institutional diversity within distinct economic systems and shifts focus to examine the nature of institutional domains in which economic actors compete and cooperate to secure rewards. If the value of political capital is unaffected or even increases for economic transactions in liberalized markets, we can infer that we will see rising from the ruins of state socialism a hybrid type of economy where the economic and political spheres remain blurred, and interventions by political actors constitute an integral part of the economic order. If, on the other hand, political capital is devalued *because of marketization*, then we can expect a devaluation of political capital, not dissimilar from established market economies (Nee, 2000).

A central advantage of a transaction-focused analysis is the more nuanced view of the fungibility of political connections. Moreover, we respond to criticism that reference to "partial reform" when results fail to confirm a decline in value of political connections renders market transition theory "immune to falsification" (Róna-Tas, 1994, p. 44). While earlier income-based approaches left the escape hatch to attribute lack of confirmation to insufficient levels of marketization (Nee, 1991, 1996), a transaction-focused approach using comparative analysis of different institutional domains leaves no room for such interpretation.

Simultaneously, the comparative assessment of the value of political capital in different institutional domains provides a more direct test of market transition theory's contending perspective which called attention to the capacity of political actors to adapt and profit from new elite opportunities stemming from marketization (Staniszkis, 1991; Oi, 1992; Burawoy & Krotov, 1992; McAuley, 1992; Shirk, 1993; Walder, 1995, 2003; Parish & Michelson, 1996; Gerber, 2001). If strategically placed political connections continue to provide access to valuable business information, giving communist cadres a first-mover advantage in emergent markets (Róna-Tas, 1994) or help to provide priority access to state assets, then a

transaction-focused approach should be able to identify the exact sources of such advantage.

For illustration of a transaction-focused analysis, we choose four specific institutional domains, exemplifying different levels of market liberalization. Following our first hypothesis, we expect that political capital will devalue the more marketized the institutional domain of the respective economic transaction.

The product market is clearly China's most competitive market. Except for few restricted monopolies such as tobacco, power, telecommunications, and railway, market entry barriers are relatively low, allowing for easy market access particularly in those industries, which require only small amounts of start-up capital and simple production technologies. China's industrial concentration ratios are low even by international standards. Price controls have been widely abolished. Whereas in the beginning of reforms in China, price controls applied to 93% of agricultural products and 100% of industrial production materials, the shares of price controls were down to 10% and 14%, respectively, by 2000 (Pei, 2006; 125). Market success thus critically depends on time to market, price-quality match, and quality of after-sales services. In parallel, local protectionism, a serious temporary problem during the mid 1980s, has weakened significantly (Li, Hou, Liu, & Chen, 2004) giving rise to rapid growth in interprovincial trade and competition. To measure a firm's success in the product market, we build on a key feature of entrepreneurial competence, the firm's ability to successfully launch new product lines. Specifically, we explore whether political connections are associated with a higher share of new products in total sales.

In addition, we examine a continuum of three partly liberalized markets with increasing degrees of state power in resource allocation. We select the public electricity market as a state-controlled factor market. In this industry, government assumed direct responsibility for electricity production. Not until after 1999, under pressure of growing industry demand for electricity, did regional initiatives begin to experiment with non-state forms of production. The restructuring of the electricity sector proceeded quickly. By 2003, only 35% of electricity was generated by state-owned firms; already 25% of electricity was generated by foreign-invested companies, including investments from Hong Kong, Taiwan, and Macao (China Data Online). As a performance measure for transactions in the electricity market, we explore the price per kilowatt-hour that firms have to pay.

It is well known that governments worldwide utilize government-owned banks to distribute political favors (Sapienza, 2004; Dinc, 2005). As a third

institutional domain we include the state-dominated banking sector. Political involvement in financial markets is particularly pervasive in China (Cull & Xu, 2000). In spite of market entry by non-state domestic and foreign banks, the four state-controlled commercial banks controlled about 70% of deposits and loans in 2003 (Datastream). In the same year, private firms and individuals received only about 1% of short-term loans of China's state commercial banks, including the four state commercial banks, policy banks, and agencies of postal savings (China State Statistical Yearbook, 2005, p. 674). Based on the legitimate assumption that any firm has a latent demand for external finance (Lummer & McConnell, 1989; Uzzi, 1999), we examine whether politically connected firms actually enjoy better access to the formal credit market than their unconnected competitors.

Finally we look at the role of political capital in the market for government contracts. Whether in mature market economies, or in China, the market for government contracts is inherently vulnerable to favoritism and bribery. Although the Chinese government has invested great efforts in streamlining public bidding procedures in line with international practice, many of our interviewees doubt free and fair competition among bidders. A young Hangzhou entrepreneur in the business of manufacturing products useful for highway construction projects relies entirely on contracts with local government. His firm submits bids throughout Zhejiang province following the standard guideline for government contracts. Although other manufacturers bidding for the same contract are known to him through public access listing, he occasionally looks into the background of the winning bid, and suspects that the firm won the competition because it has connections in local government. To explore the value of political connections in the market for government contracts, we review to what extent firm's total annual sales volume accrues to government contracts.

In addition to interviews with entrepreneurs in the Yangzi Delta which we conducted from 2004 to 2008, we use data from the World Bank Investment Climate Survey, covering a sample of 2,400 firms of mixed ownership forms in a total of 18 large cities surveyed in the year 2003 to explore the interplay between political capital and transaction outcomes in these distinct institutional domains. From the dataset, we select four different measures of political capital to assess the value of political connections. First of all, we identify whether firm managers hold a party position either as deputy secretary or party secretary. Secondly, we cover whether the government was involved in CEO-recruitment decisions. Further, we include the so-called *xia-hai* entrepreneurs as a distinct type of cadre entrepreneur. Finally, we control board membership of government officials. We noticed in a firm

that specialized in producing industrial pumps for irrigation and hydro-electric projects that one of its board members held a provincial government position. In another firm, the founding entrepreneur came from the same government agency that contracted his firm to do evaluation research for local government. Obviously, government appointed managers of privatized firms, government officials on the firm's governance structure, and *xia-hai* entrepreneurs who formerly were cadres in local government constitute clear signals of the expected value of political connections.

Table 2 summarizes sample mean comparison tests comparing the performance of firms with political capital with unconnected firms. The pattern we identify is consistent with Hypothesis 1. Political capital secures no advantages in the highly competitive product markets, but captures increasing advantages in weakly marketized institutional domains. This is consistent with what we learned in many face-to-face interviews with entrepreneurs manufacturing products for the consumer market. Even in very successful large firms, where the CEO was not only the party secretary

Table 2. Sample Mean Comparison Tests: Markets for Private Goods.

Institutional Domain	Product Market		Electricity Market		Credit Market		Market for Government Contract	
Performance measure	*N*	Share of new products in total sales	*N*	Price paid for one kwh	*N*	Access to bank loan	*N*	Share of sales to government
CEO holds party position								
No	477	36.83	1,343	0.77	1,322	0.20***	1,269	4.81
Yes	363	34.07	970	0.73	966	0.27***	894	4.39
Government was involved in CEO appointment								
No	665	35.25	1,726	0.76	1,707	0.23	1,631	3.85***
Yes	181	37.07	602	0.76	597	0.22	551	6.50***
CEO is a former government bureaucrat								
No	815	35.56	2,200	0.76	2,177	0.23*	2,060	4.19***
Yes	34	34.62	140	0.74	138	0.17*	130	11.08***
Government is represented on the Board of Director[a]								
No	363	34.98	836	0.79**	824	0.26***	785	4.49
Yes	183	36.14	349	0.70**	352	0.35***	332	4.90

Source: World Bank Investment Climate Survey.
*$p<0.10$; **$p<0.05$; ***$p<0.01$.
[a]Sample includes firms only which have a board of directors (listed firms, limited liability companies, join stock companies).

of the factory's party branch, but also active in local business and civic associations, the substance of their political involvement in government sponsored organizations and associations is often a merely ceremonial involvement to secure legitimacy, as opposed to reliance on political ties motivated by resource dependence. Many of these CEOs were approached for political office, only after they had successfully built up their firms and had become local celebrities and entrepreneurial role models.

In the electricity market, only firms with government officials on the board of directors seem to secure lower electricity prices, while the remaining types of political capital are not associated with significantly lower electricity prices. In the two tightly state-controlled markets (the credit market and the market for government contracts), political capital plays a stronger role. Firms with CEOs who are actively holding party positions and firms with government officials serving as board members have better access to credit. Also, firms with political capital linked to government involvement in recruitment decisions and operated by cadre entrepreneurs win significantly more government bids than unconnected firms. While mean comparison tests only suggest general tendencies, regression analyses confirm the predicted pattern under inclusion of a standard set of control variables (firm size, firm age, industrial sector, and firm location) commonly used in firm-level analysis (see Appendix B). Consistent with Hypothesis 1, political capital is not connected with advantages in liberalized institutional domains, while politically connected firms capture significant economic benefits in government-controlled institutional domains.

Economic transactions of firms are naturally not limited to markets of private goods. Equally important, political connections could help firms create market value in their dealings with government authorities and regulators (Róna-Tas, 1994; Parish & Michelson, 1996). Due to the continuing role of the state as the sole supplier, network advantages and political ties could easily secure preferential treatment in markets for public goods and regulatory markets. We include taxation, licensing, and the legal system as institutional domains, which have an inherent potential for rent-seeking activities. All these domains have repeatedly been cited in the literature as key areas, where the political elite may enjoy vast opportunities to create "new market value for official discretion" (Walder, 2003, p. 901). Specifically, we review the firm's access to tax exemptions, import and export licenses. We also include the perceived security of property rights to respond to the common notion that political capital may in the first place provide an insurance mechanism which lends firms legitimacy and allows for long-term planning security in the absence of rule by law.

Table 3 summarizes sample mean comparison tests. Among the four types of political capital reviewed in our tests, only firms with government officials serving as board members seem to consistently secure advantages (in three out of four transactions under review). In addition, CEOs who are holding a party position perceive a greater security of their property rights. These apparent advantages, however, are not consistently confirmed by regression analysis under inclusion of control variables (see Appendix C). Only firms with government officials on the board of directors are associated with a higher probability of holding an export license. Otherwise, the regression results do not suggest systematic advantages for politically connected firms in the regulatory market. Also the perceived higher security of property rights by firms with politically active managers disappears once we control for firm size and firm age. This signals that perceived property rights security is rather a matter of company legitimacy stemming from local market power than pure political affiliation of firm managers. This is consistent with information

Table 3. Sample Mean Comparison Tests: Regulatory Market.

Institutional Domain	Taxation		Licensing				Legal System	
Performance measure	*N*	Enjoys tax exemption	*N*	Holds an import license	*N*	Holds an export license	*N*	Likelihood that legal system will uphold property rights
CEO holds party position								
No	1,362	0.25**	1,277	0.10	1,300	0.21	1,158	62.89*
Yes	988	0.21**	924	0.10	937	0.19	873	65.83*
Government was involved in CEO appointment								
No	1,755	0.26***	1,639	0.11***	1,681	0.24***	1,518	64.05
Yes	611	0.17***	575	0.06***	569	0.12***	526	65.15
CEO is a former government bureaucrat								
No	2,235	0.24	2,096	0.10*	2,131	0.21***	1,928	64.40
Yes	142	0.19	129	0.05*	130	0.12***	124	59.34
Government is represented on the Board of Directors[a]								
No	845	0.31***	790	0.15**	812	0.31***	742	64.75
Yes	356	0.39***	339	0.19**	342	0.41***	309	68.10

Source: World Bank Investment Climate Survey.
*$p<0.10$; **$p<0.05$; ***$p<0.01$.
[a]Sample includes firms only which have a board of directors (listed firms, limited liability companies, join stock companies).

collected in our field interviews. Many of the interviewed entrepreneurs feel that local governments tend to be more accommodating once firms have reached a critical threshold in terms of economic power and local influence. It should be noted that our statistical analysis did not include the procedural aspects of public service provision, such as costs or time spent on securing specific services. Several of our interviewees mentioned that political ties may help to secure faster service and easier information access, while they did not expect a different decision outcome to result from their political capital.

Striking are the remaining results presented in Table 3, which indicate that politically connected firms may even suffer certain disadvantages in the regulatory market. Firms with politically inactive managers, and firms without government involvement in management appointment decisions, for instance, are on average more successful in securing tax exemptions than firms with political ties. Also, firms without government involvement in management recruitment and firms not run by cadre entrepreneurs are on average more successful in securing direct export and import licenses than their politically connected counterparts. In the cases of tax exemptions and export licensing, standard regression analysis confirms that politically connected firms are likely to fare worse (see Appendix C).

With a general decrease of the value of political capital in market transactions, firms need to invest in other forms of capability development in response to increasing marketization. Given a close linkage between the external environment and a firm's strategic response (Saloner, Shepard, & Podolny, 2001), the gradual replacement of the redistributive mechanism by market allocation and the resulting empowerment of economic actors combine to motivate strategic adjustments to the emergent market economy, which in turn undermine the previous institutional foundations of firm survival. The greater importance that firm managers attach to the development of firm capabilities is evidenced by rapid strategic adjustment processes. Widespread experimentation with new organizational forms, gradual divestiture of state ownership, and the emergence of new property arrangements illustrate the search for a better fit between firm strategy and external environment (Nee, 1992). Also rapidly increasing investments in research and development confirm a general shift in the firm's assessment of capability development. By 2003, aggregate R&D expenditures had surpassed India's and had increased to 1.3% from only 0.9% in 1999 (National Bureau of Statistics/Ministry of Science and Technology, 2005). Aggregate provincial-level data supports the linkage between markets and the development of firm capabilities. Fig. 2 shows a scatterplott of R&D-input development and marketization at the provincial level (measured by

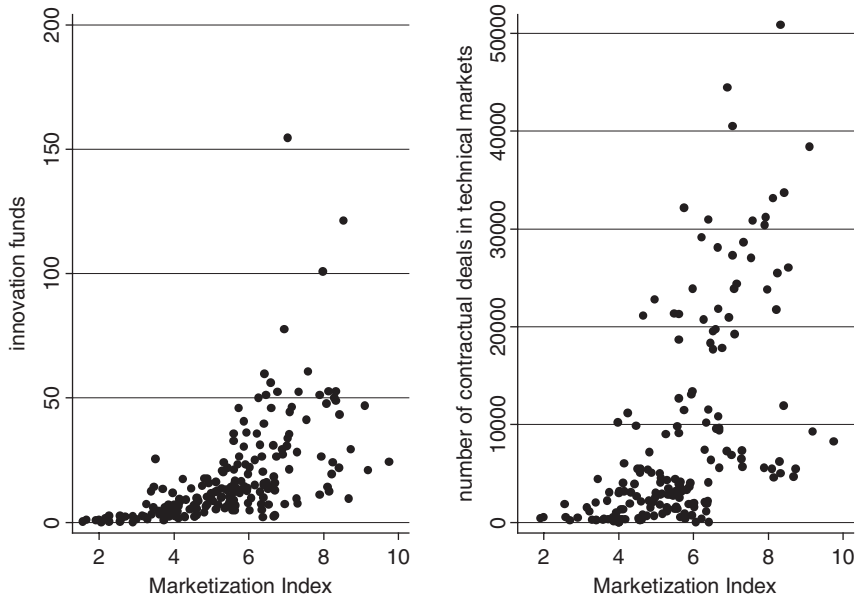

Fig. 2. Innovation Activities and Marketization, 1997–2003. *Source*: Fan and Wang (2003) and National Bureau of Statistics and Ministry of Science and Technology 2005.

the NERI-marketization index) for the period from 1997 to 2003. Consistent with Hypothesis 2, the transition from state socialist redistribution to a market allocation is accompanied by intensified capability development. Nee, Kang & Opper (forthcoming) confirm these mechanisms at the micro-level. Using a cross-sectional dataset covering more than 3,900 firm observations, they show that marketization increases interfirm competition, creates new opportunities for entrepreneurship, and subsequently motivates innovative activity. Their study yields two important findings: First, they confirm a close link between marketization and higher innovative activity by firms. Moreover, their study suggests that marketization is associated with a higher effectiveness of innovative activities and R&D networks.

A final prediction of market transition theory points at the crucial role of the opportunity structure provided by markets. Empowerment of economic actors will be most rapid, where marketization opens opportunity structures for new entrepreneurial activities (Hypothesis 3). It is worth noting that the empowerment of direct producers by the law on the books need not precede

the emergence of entrepreneurial activities. Instead, we assert that marketization itself creates opportunities and corresponding social structures that endogenously trigger problem-solving mechanisms at the grass root level giving rise to a self-reinforcing process of empowerment of direct producers. We follow White's (1981) conception of markets as self-reproducing social structures wherein market players establish a pecking order arranged by signals of perceived quality (White, 1981). Conceived, as such, built into decentralized markets are social mechanisms that enable economic actors to develop endogenously the norms and conventions of cooperation, exchange, and competition (Nee & Ingram, 1998; Greif, 2006). Through networks and embedded norms, China's private entrepreneurs built institutional arrangements that enable them to compete effectively. This includes mutual lending agreements, joint technology development, and network-based horizontal structures linking manufacturers with private sector suppliers and distributors. Although private enterprises lacked the formal institutions – legal status and secure property rights – the informal institutional arrangements of entrepreneurship sustained rapid growth of the private economy.

This bottom-up nature of China's private firm development is clearly reflected by the spatial distribution of private firm development. Direct producers first emerged in rural areas, where the state did not control all distribution channels, and where survival outside of the state-dominated system was easier. In urban state-dominated markets, discriminatory rules and barriers to entry were effectively enforced. Hence, formally registered private companies first operated in isolated rural and peri-urban niche markets where local regulatory control was less restrictive. Not until 2003, when the private enterprise economy was fully established as the most dynamic sector of the Chinese economy, did the central government grant full constitutional recognition of the legitimacy of private ownership forms. Employment data covering the period from 1978 to 2006 (see Fig. 3) illustrate that the main locus of privately owned firms shifted from rural and peri-urban markets to urban China only after the government had formally granted legal equality in 2003 (prior to 1990, official data did not distinguish between rural and urban areas).

Consistent with the rural origin of entrepreneurs, multiple surveys confirmed that the newly emerging class of private producers in the early stages of transition was not fueled by the privileged political elite. Instead, founders came from modest educational and class background, often without alternative career prospects as employees or bureaucrats in the state sector and typically without close relations with government officials (Zhang, 2007). By 1991, only about 12% of the rural entrepreneurs had held prior positions as factory or village leaders (Huang, 2008, p. 65). Clearly,

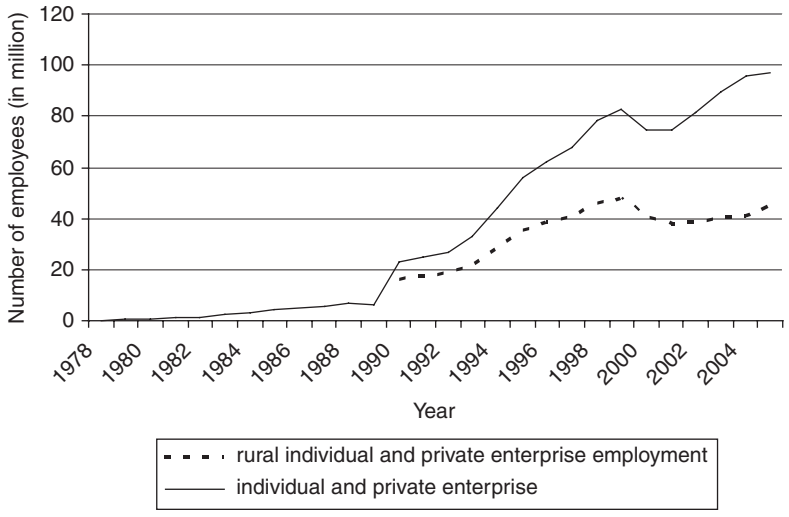

Fig. 3. Individual and Private Enterprise Employment, 1978–2006. *Source*: National Bureau of Statistics of China, 1991–2006. Disaggregated Private Employment Data for Rural and Urban Sector is Not Available for the Years Before 1990.

entrepreneurship was initially a low status affair, as confirmed by a study on social status of entrepreneurs conducted in 1987, where entrepreneurs ranked 23rd out of 38 occupations (Chen, Li, & Matlay, 2006).

Typically, rural revitalization of private production followed and accompanied the opening of free markets. Wenzhou municipality, the role model of individual private firm development in southern Zhejiang province, provides a typical example. Wenzhou benefited from decades of state neglect during the pre-reform era, when the municipality's state and collective enterprises received only modest state investment appropriations (Whiting, 2000, p. 70). Total state investments reached barely 655 million RMB between 1949 and 1981, while the neighboring municipality of Ningbo had received 2.8 billion RMB (Huang, Zhang, & Zhu, 2008). This left Wenzhou with a relatively underdeveloped state-owned manufacturing sector employing only 8% of Wenzhou's total workforce in 1978 (Wenzhou City Yearbook, 2004). Per capita income was 55 RMB, compared to the national average of 165 RMB. These conditions virtually forced the population to develop alternative sources of income generation, when market opportunities first opened up in the late 1970s. New producers focused initially on simple goods neglected by large-scale state production such as shoes, toys, textiles, etc.

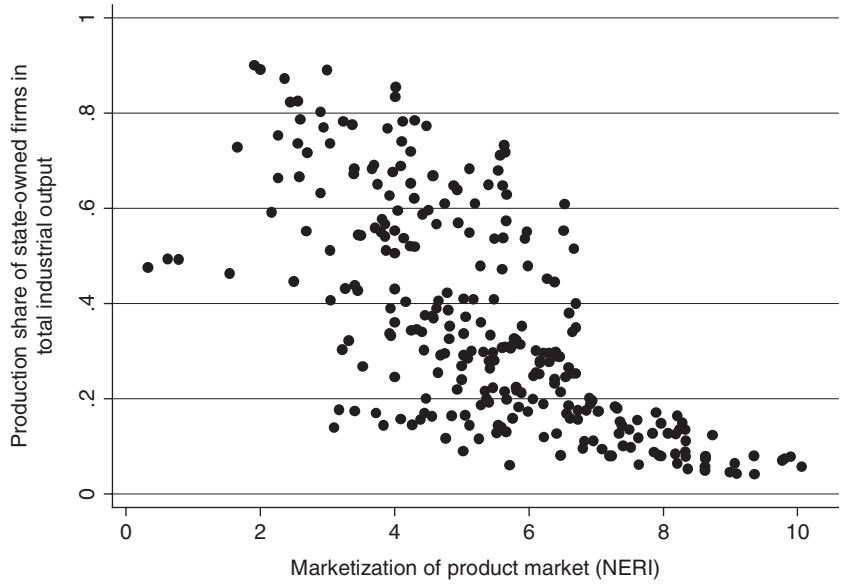

Fig. 4. Provincial-Level Product Market Development and Relative Shares of State Production in Gross Industrial Output, 1997–2005. *Source*: National Economic Research Institute (2007).

Producers in Wenzhou were relatively quick to understand the crucial role of market places. It is not a coincidence that Wenzhou witnessed massive clustering of new enterprises. Such cluster effects were supported by the government's lenient and liberal role in promoting local markets as venues for exchange of goods and information that fueled the entrepreneurial miracle. By 1985, the city registered already 472 market places, with 120 specialized factor markets Liu (1992, p. 297). Scatterplots of the development of provincial product markets and the corresponding share of non-state industrial production value between 1997 and 2005 support the assumed opportunity effect of marketization (see Fig. 4).

5. DISCUSSION AND CONCLUSION

Our transaction-focused approach opens the way for a quantitative comparative institutional analysis to examine the value of political capital as a context-bound outcome of different types of economic transactions in

distinct domains of China's market economy. We show that for transactions in competitive markets, firms with political capital enjoy no significant advantage over firms that have not invested in political connections. We confirm market transition theory's prediction that political capital persists as a fungible form of capital in markets where government restricts economic activity and controls access to scarce resources. Surprisingly, however, we cannot identify systematic disadvantages of politically unconnected firms in the regulatory markets. This indicates the emergence of a level playing field with respect to public goods provision, which is consistent with the view that China has managed to build a rational-legal government bureaucracy since the start of economic reform. Exceptions are certainly possible. Administrative decisions on public listings, for instance, seem to involve a great deal of political favoritism making market access for politically unconnected firms difficult. Overall, however, we infer from our results that in China's emerging market economy firms that rely solely on unproductive rent seeking are unlikely to emerge as winners in the intense market competition.

Whether as insurance or fungible form of capital, our transaction-focused approach opens the way for developing a quantitative comparative institutional analysis useful not only in studies of transition economies, but also in advanced market economies. Indeed, with respect to political capital, the deepening global financial crisis has increased the value of political connections to firms for largely the same underlying reasons. For example, the *Wall Street Journal* quipped in reflecting on the rapid increase in the value of corporate connections with Senator Tom Daschle, whose windfall profit of $5.2 million after leaving the Senate became a source of growing controversy in his confirmation hearings. What was of concern was not the failure to pay in a timely manner personal income tax. Instead, "The real story is the massive transfer of power and wealth now underway from the private sector to the political class. Mr. Daschle could make so much money and achieve such prominence because he was expected to be a central broker in that wealth transfer .... Had Mr. Daschle been confirmed, he would have been the most important man in a health-care industry expected to be $2.5 trillion in 2009, which is larger than the economy of France" (February 4, 2009, p. A12).

Along a similar vein, the Wall Street Journal (July 22, 2009, p. A8) reported that authorities in Africa and Europe have opened separate investigation of corruption and dumping allegations in deals involving Nuctech Co., a firm closely connected to Hu Haifeng, the son of President Hu Jintao. The younger Hu was the former president of Nuctech and is now

the Party secretary of Tsinghua Holdings Co., its parent firm. Whether or not the investigations lead to penalties, the case illustrated the correspondence between state-owned assets and the privileges and advantages of the political elite in China's market economy.

Whether in China or in the United States, political connections are valued by firms in transactions that are directed toward securing competitive advantage to acquire resources controlled by the state. Our findings suggest that such advantages, however, are unlikely to be decisive for overall firm success in China's intensely competitive market economy. Other empirical studies failed to uncover positive performance effects (based on return on assets, return on equity, or stock returns) for politically connected firms (Qi, Wu & Hua, 2000; Fan et al., 2007; Li, Meng, Wang, & Zhou, 2008). Two main reasons come to mind: First, transactions in state-controlled institutional domains often do not constitute the critical component for survival and profits when viewed from the perspective of the overall range of a firm's business operations. Second, even if politically connected firms rely heavily on repeat transactions in state-controlled institutional domains, the firm's capability development combined with management's ability to detect and react to market opportunities are likely to constitute more decisive prerequisites to pass the market test.

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APPENDIX A. MODEL SPECIFICATION OF STUDIES ON MARKETIZATION AND POLITICAL ELITE SURVIVAL

Author	Data	Year	Operationalization			Confirmation of MTT (Decline of Political Capital)
			Dependent Variable	Measures of Political Capital	Measures of Marketization (*Italics Indicate Indirect/Proxy Measures*)	
Nee (1989)	China, rural, Fujian Province	1985	Household income	Cadre position, former brigade/team position	*Before market reform, after market reform*	Yes
Nee (1991)	China, rural, Fujian Province	1985	Household income	Cadre position, former brigade/team position	No	Yes
Róna-Tas (1994)	Hungary, national	1989, 1991	Household income, employment	Former cadre position	No	No, no
Parish et al. (1995)	China, rural, Eastern two-thirds	1993	Income, employment	Administrative position in family	Repeated regressions by firm ownership	Yes, mixed
Domanski and Heyns (1995)	Poland, whole nation	1982, 1987, 1991	Income	Party membership	*Repeated tests over time*	Yes
Nee (1996)	China, rural, whole nation	1989–1990	Household income, employment	Cadre status, cadre relations	*Regions (sorted by relative industrial output of private, collective, and state-owned firms)*	Yes, mixed
Parish and Michelson (1996)	China, rural, whole nation	1988	Household income, employment	Administrative position	*Regions (sorted by ratio of non-farm labor)*	No, no

APPENDIX A. (*Continued*)

Author	Data	Year	Operationalization			Confirmation of MTT (Decline of Political Capital)
			Dependent Variable	Measures of Political Capital	Measures of Marketization (*Italics Indicate Indirect/Proxy Measures*)	
Xie and Hannum (1996)	China, urban, whole nation	1988	Household income	Party membership	*Regions (sorted by economic growth)*	No
Bian and Logan (1996)	China, urban, Tianjin	1988, 1993	Household income	Party membership	*Different years, professional categories*	No
Nee and Cao (1999)	China, rural, whole nation	1998	Household income, employment	Cadre status	Regions (sorted by relative industrial output of private, collective, and state-owned firms)	Mixed, yes
Adamchak, Chen, and Li (1999)	China, Guangzhou	1993	Total monthly income	Party membership	Subsamples for workers in non-profit institutions and profit-making firms	Yes
Dickson and Rublee (2000)	China, urban	1988	Household income	Party membership, cadre status	*Dummy variables for firm ownership*	No
Gerber (2000)	Russia, national	1993	Income	Party membership	*No measure of marketization, time (only one year after start of reforms)*	No
Zhou (2000)	China, urban, selected areas	1998	Income	Party membership	*Repeated years*	No

Murdoch and Sicular (2000)	China, rural, Shandong province	1990–1993	Household income	Party membership, cadre	*Time (1990–1993)*	No
Róna-Tas and Guseva (2001)	Russia, national	1993	Income	Party membership	*Private sector, branch, professional category*	No
Gerber (2001)	Russia, national	2000	Income	Party membership	*Professional categries, industrial branches*	No
Choi and Zhou (2001)	China, national	1993	Firm profits	Former cadre	*Repeated years*	No
Walder (2002a)	China, national, rural	1996	Household income	Cadre position	*Per capita industrial output*	No
Walder (2002b)	China, national, rural	1996	Household income	Cadre position	*Village level context (measured by average household income, nonagricultural development,* proportion of private household income in nonagricultural production, *wage-labor economy, wage employment)*	No
Bian and Zhang (1996)	China, national, urban	1988, 1995	Individual income	Party membership, cadre position	*Ratio of nonagricultural labor in non-state sectors over the state sector; ratio of foreign investments to total investments in fixed assets; industrial growth*	No
Wu (2002)	China, selected cities	1993	Individual income	Party membership, administrative rank	*Firm ownership (private versus state)*	Yes