Business strategy in China's Transition Economy: Problems and Perspectives

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I. Context

Institutional reform is a main feature of China's transition from a planned to a market economy which started in the 1980s, and is a major influence on economic growth. Specialists have published numerous studies on the process of institutional reform, such as research by Fan Gang on incremental reform (1991, 1993 and 1996), Yang Ruilong's theory of three-stage institutional change (1998) and Zhou Ye'an's take on trends in China's institutions (2000). To a certain extent, this research describes the transformation process of China's economic system.

Substitution, transformation and exchange in institutional change (Miao Zhuang, 1992) leads to the transformation of a country's institutional framework. The way different institutional arrangements interact has a significant impact on how well institutions operate. As reform towards a market economy continues and expands to the social realm, numerous inconsistencies are appearing in the country's institutional system - notably the influence of Chinese culture, in which personal contacts take precedent over official means (Fan Gang, 1995; Wang Xun, 1999). Institutional change as a result of economic transition usually leads to the gradual elimination of older institutional arrangements and their replacement in stages by modern ones. During the switch from a planned to a market system, three economic models exist (as defined by John Hicks) that together form a mixed economy: the natural economy, planned economy and the developing market economy. In terms of the institutional impact on economic activity, three principles apply to each of these models, respectively: the principle of 'relations', the principle of intrinsic regulation in state-directed economic reform, and the principle of market-steered activity with the judiciary as a third component of its implementation. This last principle is the goal of economic transition.

Complex patterns are emerging between the above-mentioned principles due to poor communications, institutional shortcomings and the limitations of government control in the transformation, concept and reorganisation of public institutions. As a result, the three following situations may occur: new institutional arrangements replace old ones, old arrangements in certain sectors are not replaced by new ones thus leading to a rupture in the institutional framework, and the inertia of old institutions impacts the new ones. The existence of old institutional arrangements as substitutes can undermine the work of new ones. The principles of relations and intrinsic regulation can similarly weaken the effect of newly operational formal institutions and re-enforce their own laxity. The co-existence of old and new institutional arrangements may also lead to opposition and conflict.

In this context, Chinese businesses are faced with a highly complex institutional environment. They must also deal with varying degrees of institutional pressure and consequently address a number of strategy issues.

II. Issues

A. State-owned enterprise reform

Tangible goods form the basis of public sector activity in a planned economy. In China, this activity is carried out by state-owned enterprises (SOEs). Every process in a SOE is influenced by the country's former planned economy, from theoretical to practical aspects, from management methods to workers' identities. SOEs are not only extremely inefficient, but also an unlimited liability for the State, which must attribute public resources to them. State-owned national resources must be flexible, not only because this quality determines their worth but also because flexibility makes economic restructuring, sector-specific policies and national economic strategies possible. In China however, the public sector economy consists mainly of SOEs, and the public spending they require strongly contradicts the need for flexibility.

Currently, SOEs are in a transitional phase where old and new institutions co-exist. One the one hand, modernising reforms mean that SOEs must develop market-based strategies while on the other , close ties with government and State provide them with numerous privileges and additional responsibilities that reduce efficiency and put SOEs in a difficult position. Maintaining a well-balanced relationship with government and State bodies has become a significant challenge for Chinese SOEs.

B. Creation of private businesses

Management - Should a business be managed by its owner or an organised management structure? In China, private business owners traditionally participate in the research, production and sales activities of their companies. The entrepreneur invests a lot of time in acquiring technology and improving product quality and management. This model, in which the skills and drive of the owner plays a key role in the performance of his/her business, is known as "entrepreneur-based management". However, as both businesses and market uncertainties grow, the pace of development stabilises, and individual entrepreneurs can no longer single-handedly steer company growth. Despite the need for an organised management system in this type of situation, most Chinese private businesses still operate using "entrepreneur-based management» methods, even if the business has reached maturity. Stagnation and even bankruptcy can occur as a result. In cases where a company does set up a real management structure, the entrepreneur and career manager may hold opposing views on management; if the latter quits, then an entrepreneur-based management system is restored within the company.

Senior management - Should senior management positions be filled by people who are close to the company owner, or by career managers? A newly-created private business is often managed by individuals who have close relations with the entrepreneur. However, when the business reaches a certain size, the quality and skills of these managers is no longer sufficient to pilot growth, and externally-hired professional managers are necessary. But China's private businesses are faced with a difficult dilemma: the extra-economic nature of capital ownership makes entrepreneurs wary of professional managers and the lack of an external market regulated by competition, means that professional managers do not perform at satisfactory levels overall.

Orientation of business activities – Should efforts focus on "quick profit" or "sustainable development"? Private entrepreneurs in China are often laid-off employees or farmers with limited education and experience, whose motivation is often purely speculative. But China's entry into the WTO and the surge in the new information economy has made entrepreneurs aware of the need for long-term investment to boost the competitiveness of their core activities. They soon learnt that sustainable development comes at a very high cost and yields poor short-term returns. Those entrepreneurs who are determined to invest with a long-term perspective, are unable to compete with large foreign companies.

Management philosophy – Should strategy focus on developing famous brands or on waging price wars? Because of the high cost of resources and a lack of preferential measures, many private Chinese businesses rely on product sales to cover investment costs. As a result, companies are rapidly drawn into price wars as soon as they are created, and end up using known brands merely to bring in short-term profits.

Management methods – Should they be about product performance or non-productive activities? In recent years, private Chinese businesses have stubbornly continued to focus efforts on non-productive activities at the expense of R&D, production and quality control. Although aware of the importance of performance, businesses using a management strategy based on product performance are currently yielding poor short-term results, thereby putting their own survival at risk.

Business strategy – Should companies go for globalisation or localisation? Many private businesses on the Chinese market have broken into the international markets while others have failed because they were unable to develop an effective globalisation strategy. Others still have failed to seize on opportunities despite being sufficiently competitive and having a good chance at going international.

Development strategy – Should a company diversify or specialise? It is commonly acknowledged that many of China's flourishing private businesses developed by using the reform process and institutional privileges to their advantage. Entrepreneurs of transition-phase companies expand their business considerably by diversifying, but unfortunately most do so blindly, leading to inefficiency and a poor distribution of capital. Other companies continue to adopt risky strategies based on specialisation in sectors experiencing a decline or downturn.

Managing for the future – Is it better to expand production or boost R&D? Thanks to its abundant, cheap labour pool and massive levels of fixed investment, China has become the "world's factory". But becoming a country that invents requires investment in science and technology in addition to improved R&D capacity. China's private businesses are faced with the difficult decision of whether to expand production or increase investment in research and development.

III. In-depth analysis

The issues discussed above show that both state-owned and private businesses are strongly affected by their institutional environment. Moreover, previous development patterns will heavily influence future ones due to a "path-dependence" effect. The disadvantages created by this phenomenon in a market economy multiply as China's economy becomes increasingly international.

To transform Chinese business strategies, institutional impediments to new methods must be eliminated and replaced by reforms to improve the socialist market economy and build the institutional basis of intensive growth. More specifically, reform should focus on:

<u>The continuing improvement and restructuring of the property system</u>

At one end of the spectrum, greater efficiency is needed in public spending; SOEs and companies in which the State is a shareholder need to be improved through institutional reform and better governance. At the other end, private sector development should be encouraged. To improve access to the market, the rule of law must be diligently upheld so that all citizens may exercise their rights to engage in any kind of legal activity without seeking permission from the government.

<u>Improving education and culture, and establishing new regulations</u>

One purpose of the education system is to supply the country with a specialised and skilled workforce. But rather than simply providing businesses with researchers, the main goal of education in China is to develop a market-oriented culture in the workforce, particularly in high-level management and shareholders. Improving the education level can also help the public to obtain objective knowledge about networking and market competition. We must abandon our cultural and intellectual prejudice against private shareholding (excepting where the state is a shareholder) so that new institutional frameworks become the point of reference for all shareholders. Business across all sectors must realise that their survival and expansion depends on their ability to compete on the market.

Further improving property laws and related regulations

Our analysis shows that legislation and public policy exert considerable influence on how a business develops and carries out its strategy. Efforts by the State to add flexibility to the legal environment would encourage businesses to respect the rules of the market. Much needs to be done to improve and complete policy intended to encourage market-oriented development. For example, the success of venture capital depends on the free movement of investment capital; in China however, corporate legislation limits the number of shares a company may buy back and prohibits the floating of company shares on the market. These restrictions have a negative effect on capital mobility and prevent shareholders from influencing a business's strategy by modifying the size of their stake in that company.

The government must also adjust its policies to accompany legal change. Businesses must be encouraged to develop market-oriented strategies, and their earnings protected as a means of reassurance. Upholding and applying intellectual property laws not only protects the well-earned rewards of inventors, it also encourages innovation.

IV. Key issues

The need for institutional legitimacy – For a business to survive and grow, it not only needs to perform well, it must also be 'legitimate', with management methods and goals that conform to society's expectations, customs and values. Legitimacy confers a certain status in the social environment and makes it easier for a business to attract resources and the solid support of stakeholders. Conversely, a lack of legitimacy can badly affect a company's capacity to achieve its goals and accumulate resources. Institutional theory identifies three types of pressure for legitimacy: coercive, normative and mimetic (DiMaggio & Powell, 1993). Each type of pressure influences different companies in different ways. Companies must meet a wide-range of criteria to acquire legitimacy in countries with a transition economy and a complex institutional environment. This kind of pressure affects the strategies of public and private companies alike. Further research is required to understand the exact effect of each type of institutional pressure on businesses.

Changing business strategies in a changing institutional environment – Change is a constant feature of the economic transition that involves a shift from a planned to a market economy. Business strategies must therefore also evolve according to changes in environments, and influence the direction of those institutional changes. As institutional pressures evolve, should business strategies do the same? How? Should businesses follow change or resist it? Should a new institutional framework be created to encourage business, or should current policy be maintained? Further research is needed to answer these questions.

Main institutional factors in business strategy – Organisations vary across sectors but only a few of the differences between them have an effect on business strategy. These institutional factors need to be studied further. Current research shows that the size of a firm plays an important role. Large firms with greater resources and a higher degree of specialisation are more sensitive to environmental change and benefit more from public policy measures. The greater the public stake in that company, the more a company feels institutional pressure – legal and regulatory in particular. Moreover, certain institutional factors lead to differences in the way a company obtains information and how fast it circulates. The relationship between businesses may also affect the strategies they adopt (Scott, 2001). Again, further research is needed to understand how institutional factors influence business strategy.

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