INSEAD

The Business School for the World®

# Faculty & Research Working Paper

## Post-Transition China

Gordon REDDING
Michael A. WITT
2010/25/EPS/EFE

# Post-Transition China

By

Gordon Redding *

and

Michael A. Witt **

Forthcoming as Chapter 2 in Peter Sheldon, Sunghoon Kim, Yiqiong Li, and Malcolm Warner (Eds.), *China's Changing Workplace*. London: Routledge.
The final published version is likely to differ slightly in details such as format, phraseology, and punctuation as a result of the copy editing process.

* Adjunct Professor at INSEAD, Boulevard de Constance, 77305 Fontainebleau, France; Phone: +33.1.6072.4001; Fax: +33-1-6072-4049; Email: gordon.redding@insead.edu

** Affiliate Professor of Asian Business and Comparative Management at INSEAD, 1 Ayer Rajah Avenue, Singapore 138676; Phone: +65.6799.5253; Fax: +65.6799.5399; Email:michael.witt@insead.edu

## Abstract

Economic activity in China, and indeed anywhere in the world, is embedded in, and shaped by, a complex web of societal factors that in their entirety form what is known as a ‘business system’. The objective of this chapter is to provide a brief exposition of the main business systems present in today’s China—state-owned, private, and local corporate. We begin by explaining the notion of a business system and its component parts and then apply the business systems approach to the case of China. We conclude by posing three major questions for the future evolution of the Chinese business systems, and thus for the future of the Chinese economy more generally.

Keywords: China; State-owned Enterprise; Private Enterprise; Local Corporates; Economic Development; Varieties of Capitalism; Comparative Business Systems; Complex Adaptive Systems

## About the Authors

Gordon Redding (Gordon.REDDING@insead.edu) did his Ph.D. at Manchester Business School after a managerial career in the UK, then spent 24 years at the University of Hong Kong where he was founding director of the Business School. At INSEAD since 1997, he has been Director of the Euro-Asia Centre and a Professor of Asian Business and Comparative Management. His research interest is the evolution of the Chinese forms of capitalism seen against the comparison of systems of capitalism globally.

Michael A. Witt (Michael.WITT@insead.edu) earned his Ph.D. at Harvard University. He is a Professor of Asian Business and Comparative Management at INSEAD and Associate in Research at Harvard’s Reischauer Institute. His work focuses on comparative business systems and institutional change, especially in the East Asian context.

Among the joint publications of the authors is *The Future of Chinese Capitalism: Choices and Chances*, Oxford University Press.

An appreciation of labour relations is a prerequisite for understanding Chinese development and its likely future trajectory. At the same time, such appreciation *alone* is not sufficient, neither for understanding the larger picture of the Chinese economy nor for accounting for changes in the labour relations system itself. Economic activity in China, and indeed anywhere in the world, is embedded in, and shaped by, a complex web of societal factors that in their entirety form what is known as a 'business system' (see Redding 2005; Whitley 1999). Labour relations interact with many of these societal factors, in the process both receiving and exerting transformational influences.

The objective of this chapter is thus to complement and contextualize the other chapters of this book by providing a brief exposition of the main business systems present in today's China—state-owned, private, and local corporate. We begin by explaining the notion of a business system and its component parts. We then apply the business systems approach to the case of China; given space constraints, we will by necessity be painting with a broad brush, and we refer readers in search of finer differentiation than this chapter can provide to our earlier work (Redding & Witt 2007). We conclude by posing three major questions for the future evolution of the Chinese business systems, and thus for the future of the Chinese economy more generally.

## UNDERSTANDING BUSINESS SYSTEMS: A FRAMEWORK

Societies are complex adaptive systems in which change, generated both internally and externally, is constant (Beinhocker 2005). Analysis of these systems requires recognizing certain basic rules, including: the categories of a given framework are simplifying abstractions from reality, created to facilitate thinking about common features across societies; these categories do not exist in isolation from one another but are interlinked and interdependent with reciprocal flows of causality; both the contents of categories as well as their connections change over time, and even though stable patterns—punctuated equilibria—may evolve, it will not remain stable forever; and lastly, even if the entire system is remains in flux, stable patterns can be identified within it, with enough staying power to explain a society's business system at present and to help judge its direction of emergence.

Following Whitley (1999) and Redding (2005), we propose that a society's way of doing business—its business system—can be understood in terms of three main categories: its cultural underpinnings, that is, the realm of meaning; its institutional context, that is, its structure of societal order; and its organizational patterns of coordination, that is, its means of creating cooperation within firms. Each of these breaks into further component parts, which we briefly define as follows:

Culture, defined as the social construction of reality (Berger & Luckmann 1966), forms the basic layer of the model. It is what holds functioning societies together psychologically. It interprets meaning for the members of a given society, that is, it helps make sense of reality so individuals can understand it sufficiently to cope with it and to attribute significance to certain actions and characteristics.

For the sake of analytical convenience, we propose to disaggregate culture into three main components. The first, and arguably most important, is *rationale*. It captures a societies notion of the ends of economic behaviour and the accepted tools toward these ends. In the context of the business system, one key question thus is, what are the reasons for the existence of firms? In other words, what ends do people have in mind when they do business? Attached to this, what means do they think appropriate in its conduct? The answer students usually receive in today's business school environment is, 'shareholder value,' with concomitant notions of appropriate means including corporate governance, HR management, financing, etc. The reality is far more complex, with different societies having developed vastly different answers to the question—shareholder value being the exception rather than the rule—as well as very different notions of the ideal shape of the economy (Witt & Redding 2009a, 2009b).

The other two elements of culture are those defining order and thus underlying a society's basic architecture. Horizontal order, or *identity,* refers to a sense of belonging, of identification with others. Broadly speaking, do members of a given society think of themselves as independent individuals, or as members of one or several groups commanding their loyalty? If the latter, what group(s)? Vertical order, or *authority,* relates to a person's position in a power structure. How strong is hierarchy in society? How does one get authority, and who has it?

The middle layer of the framework refers to the institutional context in which firms are embedded, and specifically, the institutions governing the availability of the three major forms of capital: financial, human, and social. Under *financial capital,* the model explores the rules by which capital becomes available and allocated. Pertinent questions include the main sources of capital—e.g., banks, markets, informal finance—as well as the rules of allocation and the extent to which capital is patient (i.e., not quickly withdrawn). Under *human capital,* it captures the rules governing skill acquisition, organization of labour, and the time horizon of labour availability. *Social capital* is what enables voluntary cooperation among people—in essence, trust. It comes in two varieties, interpersonal (i.e., that existing between two individuals, usually on the basis of past positive interaction) and institutionalized (i.e., trust on the basis of legal systems, as in most of the West, or of social pressure, as in Japan).

The top layer of the framework is the business system in a narrow sense, that is, the forms of coordination by which necessary components in business are brought together into stable and understandable arrangements. These govern how financial, human, and social capital ultimately combine to produce positive economic outcomes. The first of three components in the business system is coordination through *ownership*—who owns firms, and to what extent does the owner have control (thus incorporating corporate governance in its original sense). Second, firms may coordinate across firm boundaries through social *networks,* that is, repeated interaction among actors that are formally independent from each other. Third, *management* refers to the question of how things are coordinated inside the firm—how the key resources are made to flow together, as managers seek the necessary efficiency, learning, and adaptiveness, for the firm to prosper.

Understanding the interactions among the various component parts of the three layers requires a sense of history, and in particular of the key events that shape a society's sense of self and distinctiveness. All societies have definitive historical experiences. Some of them are very clear, such as the Code Napoleon in France or the social reforms of Bismarck in Germany. Others are less specific but not necessarily less powerful, such as the notion of manifest destiny with concomitant access to untapped resources in North America in the $19^{th}$ century, or the importance of Hong Kong as an economic intermediary between China and the West.

Influencing and shaping the elements of the framework at all levels is the state as a key conditioning force. Though the state is an actor rather than an institution, the actions of the state themselves are governed by formal and informal institutions, and as such, it is possible to discern general patterns of state behaviour. For example, some states are more interventionist than others, and there tend to be patterns in the areas in which states intervene and how they do so. Some states share economic risk with firms, others refuse to do so. Decision-making patterns, and avenues for civil society to influence them, vary. In short, how the state proceeds with governing the economy has a major impact on the remaining elements of the system and the resultant outcomes, as illustrated, for example, by the contrast between China's 'strong' state and India's 'weak' state.

Last but not least, a full account of the forces shaping the business system needs to take into account that any system is open to outside influence. Such influence can be crucial in its effects, as was for instance the impact of Marxist ideology on Russia, or the effect of access to Western markets and technology on Taiwan after 1950. We see these influences here to consist of two main kinds, the material, and the ideational.

Figure 2.1 provides an over view of the resultant model. It is clear that this model is not built for maximum parsimony, but for affording a holistic view of the rules of the game shaping economic action in a given society and their interdependencies.

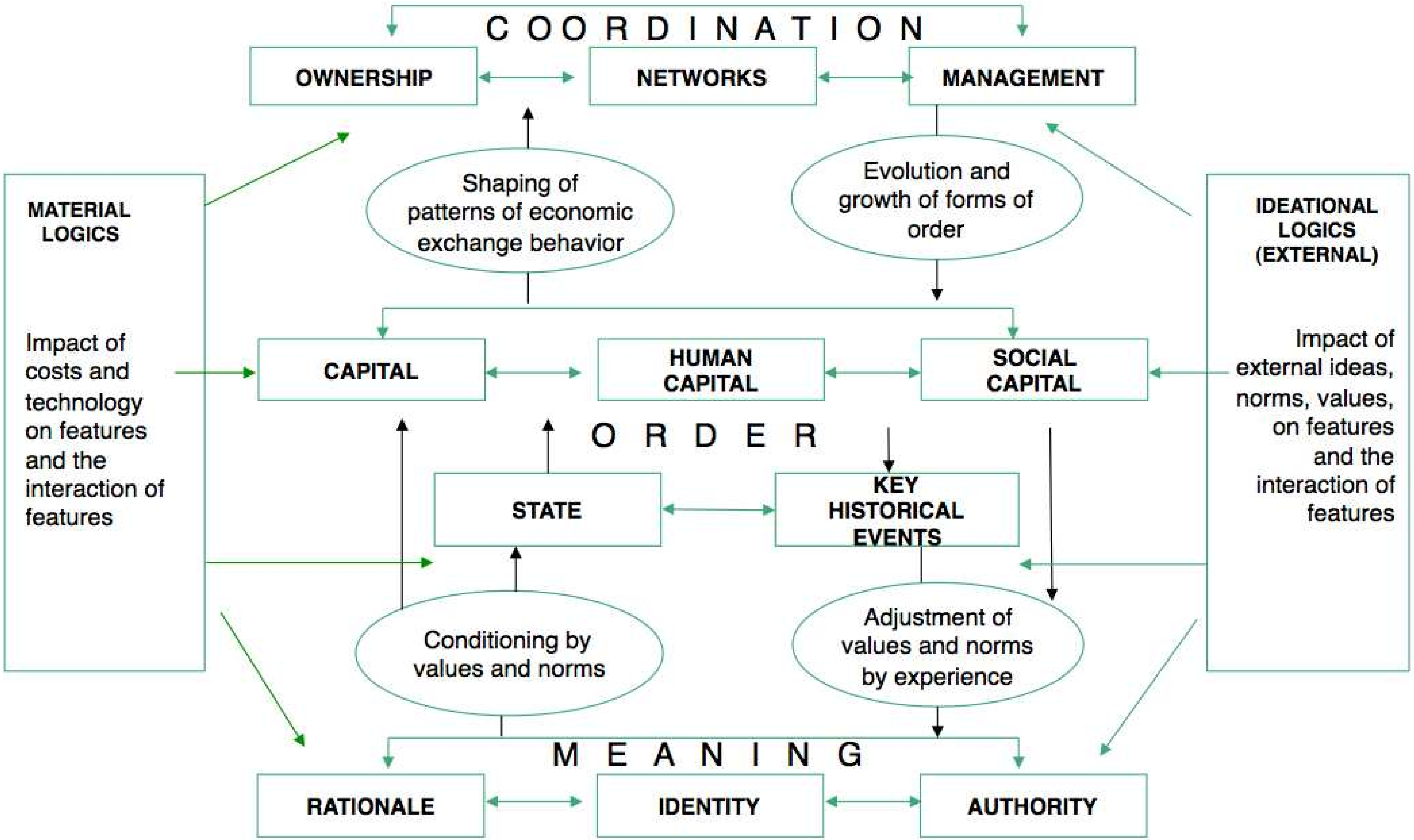


**Figure 2.1: Business Systems Framework**

## BUSINESS SYSTEMS IN THE PEOPLE'S REPUBLIC OF CHINA

There is no one single dominant business system in present-day China. There are many. The challenge scholars have been facing is finding sensible broad categories that help make sense of the overall picture, with the understand that there are bound to be plenty of exceptions and special cases as well as geographic variations. With this caveat in mind, we propose that China today features three main forms of business systems, which are as follows:

> 1. The *state-owned sector*. This used to be the dominant form under Mao, but has since undergone reforms—most clearly in the 1990s under Zhu Rongji—putting them under pressure to perform or go under. Most state-owned enterprises (SOEs) are large, bureaucratic, and capital intensive, and they are commonly protected from controlling outside ownership.
>
> *2.* The *private sector.* Illegal until the 1980s, it now accounts for about two thirds of GDP. It consists mostly of family-owned small and medium-sized enterprises and exhibits high levels of entrepreneurship.
>
> 3. The *local corporates.* This business system comprises a large variety of firms, with the common theme that many of them evolved out of so-called collective enterprises—i.e., those whose state-ownership was administered at a local level of government. They tend to blend private initiative and investment with local government involvement and concomitant use of state resources, including access to plants, land, labour, and financial capital.

Below, we explore these three types of business systems inside China through the lens of the business systems framework introduced earlier. Given space constraints, we will by necessity be painting with a broad brush; an exposition in more detail is undertaken elsewhere (Redding & Witt 2007). In particular, we will omit a discussion of key historical events. Furthermore, we will for the most part refrain from explicit discussion of the characteristics of local corporates, noting upfront that their characteristics tend to lie between the extremes demarcated by the other two business systems, though more toward the private sector side.

### Rationale

Two main notions of the reasons why the firm exists seem to exist in present-day China: to make money, and to aid economic development and thus the re-emergence of China as an economic great power. The salience of these objectives varies by business system. In the private sector, especially in smaller family businesses, the focus is very strongly on the generation of a means of living and, ultimately, family wealth. This mode of thinking resonates with the historical focus of Chinese family business, as is visible among the Regional Ethnic Chinese in Southeast Asian countries, Hong Kong, and Taiwan. Suppressed under Mao, it reasserted itself after his death and the beginning of economic reforms in 1978 and was finally re-legitimized by Deng Xiaoping's equation of wealth with glory. At the same time, many entrepreneurs seem to believe that personal enrichment also serves the second goal of Chinese economic development.

Conversely, the state-owned sector seems to emphasize the importance of working toward economic re-emergence. In this view, especially the large ‘core SOEs’ under the umbrella of SASAC, the State-owned Assets Supervision and Administration Commission, represent state tools toward driving economic development and a Chinese presence in industries that are considered strategic. At the same time, in recent years, government has increasingly pushed these firms to earn their keep.

**Identity**

Similar to the objective of family wealth, the traditional sense of identity in Chinese society proved stronger than Mao’s reform efforts. Chinese society is collectivist, with the family as its key reference group. Around it follow concentric circles of affiliation; in order of decreasing strength of ties, these are usually the extended family and clan, friendships of various depth, and, loosely, people from the same general geographic area of origin. Identification with the workplace is usually weak to non-existent among private firms. In the state-owned sector, affiliation to a work unit may still represent one of the concentric circles, albeit one that is unlikely to be strong given years of market-oriented reforms in the sector.

**Authority**

Chinese society continues to be strongly hierarchical. Some of the bases of authority have carried over from olden times, and especially from Confucian traditions. These include respect for education and age as well as a residual preference of males over females, as evident in the high number of abortions of female foetuses by parents keen to produce a male heir to carry on the family lineage. Wealth, disdained in the Confucian world order and under Mao potentially lethal, has emerged as a powerful basis for status. In addition, the Communist Party represents a basis of hierarchy in society, a fact most acutely felt in the state-owned sector.

**Financial Capital**

The rules of the game for finance vary considerably by business system. The state-owned sector has access to both, banks and the stock market, and some authors estimate that up to 99 percent of bank loans made to Chinese enterprises go to SOEs (Tsai 2007). Cost of capital here is typically very low, and creditors—effectively, state-owned banks—are very patient in terms of getting their money back. Conversely, the private sector tends to be starved of capital. Stock market listings are possible mostly for the very few large firms whose owners are well-connected enough to secure permission for an IPO. Banks usually do not lend to private businesses, with the result that these tend to be dependent on equity and informal loans from family, friends, and unlicensed lenders. Local corporates usually tend to have good access to finance through their close connections with local governments.

**Human Capital**

As this is the theme of this book, we will be brief on this point. In general, the availability of skills remains a problem throughout the economy. Public training is weak. On the job training in the private sector is hampered by short employment tenures; state-owned firms seem to continue to keep their employees for relatively longer periods of time, though it is not clear whether those who stay—rather than open their own business or work at a higher wage for a foreign firm—are good-quality workers. Organization of labour occurs through unions at the company level, with the All China Federation of Trade Unions, a branch of the Communist Party, as umbrella organization.

**Social Capital**
Social capital, or trust, tends to be interpersonal in nature. It is strongest at the core of the concentric circles of affiliation noted under identity and weakens with distance from the core. People outside these circles are usually met with mistrust, and the relationship with them is seen as one of zero-sum competition. Institutionalized trust—the ability to trust strangers by virtue of the presence of a system keeping people honest, such as a legal system as in the West or strong social pressure as in Japan—is basically absent.

**Ownership**
This again represents an area of much variability across business systems. State-owned enterprises are obviously state-owned, though many of them are now listed on stock exchanges and thus at least partially in the hands of domestic and foreign shareholders. Ultimate control, however, continues to lie with the state, which also usually appoints the top management from among party ranks. By contrast, private business tends to be owned and controlled by individuals and their families. The picture is somewhat murky for local corporates. Some may look like private enterprises, only to reveal considerable government ownership upon closer inspection. Overall, most of them seem to be co-owned by private and local government interests, which exert joint control.

**Networks**
Lateral, non-hierarchical connections across enterprises tend to be relatively weak in the Chinese context. In the private sector, cooperation among enterprises can occur, for instance, in the context of the vaunted production networks that account, among others, for 70 percent of the world market in cigarette lighters. In many cases, these networks are coordinated on the basis of personal connections, either of the owners or of a purchasing agent. In the state-owned sector, horizontal coordination tends to be rare unless government wills it, in which case it becomes hierarchically imposed and ceases to be a form of networking in the usual definition (cf. Podolny & Page 1998).

**Management**
Decision-making in China tends to be a top-down affair. Delegation is hampered by a lack of institutionalized trust, so to the extent a firm has middle managers, their role is mostly to serve as a conduit and enforcer of orders rather than as a contributor to steering the firm. In the private sector, power tends to be concentrated in the hands of the owner-manager, the *laoban*. In the state-owned sector, the state represents the ultimate decision-maker, especially on major strategic matters. Promotion through the ranks is partially based on skills in the private sector, though top management is usually reserved for family members or very close confidantes. In state-owned enterprises, seniority seems to continue to matter. However, top-management often comes in from the outside on the basis of state appointments.

**The State**
The role of the state represent another area of large variations. Policy has re-legitimized the private sector and has created a basic regulatory framework, though even where well-written laws exist, implementation is spotty and at times arbitrary. Beyond this, promoting private business does not seem to be a major item on the national policy agenda. This is evident, among others, in the poor availability of financial capital already noted.

By contrast, the state-owned sector has been on the receiving end of much state policy. Part of this aimed at privatizing or closing down SOEs deemed to be non-essential. On the other hand, government has heavily promoted those SOEs seen as essential, using industrial policy measures reminiscent of those pursued by the Japanese during their post-war miracle (cf. Johnson 1982; Nolan 2001). The ultimate goal seems to be for China to cultivate its own large-scale national champions in a range of industries policy-makers consider strategic, including resources as well as a large range of manufacturing and service industries. Main beneficiaries of Chinese industrial policy have been the SOEs supervised by SASAC. At the time of this writing, SASAC identifies 150 firms as 'central SOEs.'

Local corporates again seem to fall somewhere in between the extremes. While the central government tends to treat them in similar ways as private business, local governments often foster their growth, be it through local policy measures or plain preferential treatment. Local officials have multiple incentives for doing so. Their future career prospects depend on economic performance of their respective territories; local corporates add to the local tax base; and it is apparently quite common for local government officials to hold a personal stake in some of these businesses.

Backdrop to all of this is a high degree of decentralization of the Chinese state. Because of the size of the country and slack in the government structure, full enforcement of central government policy has always been a challenge—as the old proverb goes, the heavens (also: mountains) are high, and the emperor is far. Subsequent to the beginning of economic reforms in 1978, policy-makers found that this feature might be useful for evolving information about the feasible directions of economic policy. For instance, the municipality of Wenzhou in Zhejiang prefecture registered extremely high levels of growth in the early 1980s, in the process breaching many central government economic laws and regulations of the time and devising its own local regulatory framework (Witt & Lewin 2004). Upon discovery of Wenzhou's success, national media widely presented it as a new model for other localities to follow. Formal decentralization followed in the 1990s, and in terms of the proportion of taxes received and spent locally, China's government structure is more decentralized even then Western federal states such as Germany and the United States (OECD 2005). The overall effect is that while the central government to outsiders seems all-powerful, it in reality has very limited control over what happens in the country's regions, and local governments are a key driver of economic policies.

**External Influences**

Of specific importance to the Chinese context have been in particular three sources of such influences. First, inward foreign direct investment (IFDI) as both a driver of economic growth and a source of learning and institutional innovation. Second, as a subset of the first item, the heavy involvement of the Regional Ethnic Chinese of East and Southeast Asia in the Chinese economy, providing more than half of IFDI. In addition to the effects already noted for IFDI in general, the Regional Ethnic Chinese played a key role in re-establishing family business as a form of doing business, having preserved the basic principles outside the mainland during Mao's rule. Third, Western and Japanese ideas of economic and management principles.

All of these elements of the business system are in constant complex and reciprocal interaction, simultaneously shaping other elements and being shaped by them. Often, elements form complementarities, that is, elements depend on one another in order to function properly. The result is that economic reforms are fraught with difficulty and the risk of unintended consequences, though the decentralized, bottom-up nature of institutional changes in present-day China mitigates these challenges somewhat.

## CHALLENGES ON THE ROAD AHEAD

So far we have argued that you have to look at any society—and especially one at the scale of China—as a *complex adaptive system*. It is also useful to bear in mind a belief shared in much Chinese philosophy, namely that social systems are capable of ordering themselves if the ground rules for conduct are clear and well protected. One of those ground rules in China is that the state must always retain enough control to discharge its sacred responsibility to the people. But along with that belief in constrained self-ordering goes a logical consequence—that planning the future is largely fruitless and unnecessary. Adjustments can be made to shape things as they go along, but new combinations emerge of their own accord rather than from a drawing board.

Unlike under Mao there is now no specific industrial policy being pursued that would contain a component devoted to employment. There is an intention expressed as a target for living standards, but not a chosen route except for the all-encompassing 'socialist market economy'. This is now an experimental state, a huge laboratory. In its varied collection of results trends are clearly visible, and could be predictable, but no authoritative source of future intended structures exists. This is not intended as a critical comment, in fact quite the opposite, as such a response shows a sophisticated attitude to state governance. It compares favourably with societal planning conducted often elsewhere, and once in China. In those other cases there is often too little acknowledgement of the restricted nature of human control over complex events, and an ignoring of the human motivations that underlie action.

At the same time the evolving of societal systems is not entirely random. Certain ground rules for successful progress can be defined and observed working. It is with these in mind that we now look ahead, not so much to predict specific outcomes but instead to identify challenges and tensions that will shape outcomes. Such are likely to be the battlegrounds over which contending solutions will compete. By this means we hope to define the issues in coming debates and to raise awareness of what lies beneath many of the trends so ably described elsewhere in this book by our colleagues.

So what are the rules that govern the successful evolution of societies and economies? Can anything be said that applies to all societies? We start with two fundamental conditions. In societies that have prospered there has always been a mixture of *diversity* and *dynamism* as starting conditions. When diversity is absent—as under the universal sameness of 1960's China, when everyone depended on the state and wore blue or grey denim—then the chances of progressing are hindered. People stop thinking of alternatives and conformity becomes an ingrained habit, often perhaps reinforced by fear if deviance is punished. Without it, there is no multiple experimentation from which successful formulae can emerge. They might otherwise never come to the surface. The farming reforms of the 1970s that started the post-Mao revolution were regional deviations conducted at high risk. Hong Kong and Taiwan acted like revolutionary cells until the special economic zones were created to keep their effects limited. It took time for the diversity to become legitimate but it has since become standard. Looking forward it would be hard (but not impossible) for authorities to reverse this trend; people have got used to having options and this is a version of freedom.

Dynamism is different in nature but the two forces complement each other. Dynamism results from interchange and exchange but that can only happen when people are free to take initiatives, in other words they have enough independence to conduct exchange, and enough command of resources to make it worthwhile. Historically China was a very dynamic society, in that it was buzzing with commerce, industry, and trading within its many regions. The Grand Canal was a major trade route, and markets thrived in a highly organized fashion under the watchful eyes of the mandarin administrators. But organizations were generally of small scale, except for those involving the state, a tradition perpetuated now. Even though the emergence of national markets has always been inhibited by the sheer scale of the country and the natural barriers of distance and topography, there was usually enough within each region to maintain a thriving commerce.

Until very recently it had seemed that China might be expected to revert to its accustomed regional structure, and the power and competitiveness of its provinces has been witness to that. But two features are new: the internet is reducing the effects of geographical distance; and massive investment in new transport infrastructure is ushering in an age when a national market in goods and capital may appear for the first time in Chinese history. New legislation permitting labour movement without penalty is likely to make labour markets national also, even though the full effect may take a long time to appear. These two new features are likely to foster an increase in dynamism as the forces of competition take a stronger hold on a wider area of economic life.

The Deng revolution let loose this pair of benevolent spirits, at first by giving the farmers some rights of ownership, and then later in decentralizing power to the provinces and cities. This fostered variety and experiment away from the gaze of the centre. China has since then been experimenting on a scale that has now reached colossal proportions. Its variety of organizational types is a tribute to this, even while that variety is not endless. The choices are restricted by limits set by the context.

Having got the machine running the next question is how to make it perform to the best effect. Here the question may be sub-divided: In organizations can performance match global standards of competitive efficiency? Can the society progress towards goals such as (among others) income per capita equal to that in other societies they would like to match? How do societies progress to the highest levels of income, the longest life expectancy, the equal distributing of benefits, and the most stable conditions for conduct? The answer—again working backwards from the successful cases to search out the universals that seem to apply to the majority—lies in three achievements (Beinhocker 2005). They can act as criteria against which a society can measure itself and they can be simply stated, but not simply achieved. They are *innovativeness, adaptiveness, and efficiency.*

The innovativeness can be in products, processes, new combinations, new methods of communicating, new institutions, new rules, or all of the above. The adaptiveness is a necessary corollary if the maximum is to be realized from the innovation, and it applies at all levels—people, organizations, institutions, government. We see the example of Japan as a state where innovation runs high in many industries - although not all, but where the political superstructure and the upper echelons of big companies remain cripplingly conservative.

The question of efficiency is at heart a question of whether key resources such as capital and human capital and technology flow to the opportunity spaces where they can be combined in the most productive way. This calls into question both efficiency in allocation (as with flexible labour markets or efficient capital markets) as well as efficiency in use via productivity. Variations are clearly visible in data for productivity per unit of input, and rates of return on capital. In this the role of human and social capital can be as crucial as that of finance, and the relevant use of all three will determine the global competitiveness of industry. We may therefore question China's capacity to meet these universal demands, but in doing so we must accept that the way the demands are met may well show distinct Chinese responses.

A simple review of major trends must begin with a realistic acknowledgement that the miracle of China's resurgence since 1980 has been supported by the availability of huge resources within the state. Just as the nineteenth century prosperity of the US rested on access to an entire resource-rich continent treated as empty, so too is it arguable that China's current economic power rests on historically sudden use of one of the world's last huge land banks owned entirely by government. Added to this has been the massive value of low cost skillable labour in flexible supply. Such comparative advantages are rare and are especially valuable in conditions of strong central control when their use can be orchestrated, even if that is now by remote control. The remark by Mrs Thatcher that India had done the hard part first evokes a key theme for this book: once the slack has been taken up what then drives the advance at the same rate? Will that be the hard part for China? When will it kick in? How will China find within itself a response that is competitive in a very fast changing world?

The emergence of the three different business systems and their characteristics noted earlier in this chapter would not have been possible without a great deal of loosening of control over business behaviour and at the same time a great deal of improvement in the predictability and effectiveness of the surrounding fabric of societal order. Law became both more predictable and less controlling, as rights began to be incorporated and acted on. Standards of openness in information improved, as did accounting. Competition and level playing fields were sponsored strongly by the World Trade Organization as conditions of China's membership.

The China we see today is still in radical transition away from its past, and yet it carries much of that past with it, and that legacy will shape its response to meeting the challenges noted above. Let us now review the probable future states of tension between those challenges and the legacies of China's five thousand year history.

**Innovativeness**

Just as Japan may be praised for innovativeness and efficiency but criticized for weak adaptiveness, China may be praised for adaptiveness and efficiency but criticised for weak innovation. But to understand that point requires us to unpack the meaning of innovation, as China does have certain forms of it. And it certainly has an alternative in technical borrowing that has served it well so far. To understand the issues we have to enter into the worlds of human and social capital.

A society with high levels of innovation does not have one single feature that produces that effect. Innovation rests on a configuration of connected features. That is why it happens differently around the world. But however it is organized it still has to be worth peoples' while to take risks, to explore options, in other words they need to be able to capture for themselves enough of the value they create to make the effort worthwhile. So too there needs to be a way of connecting the purer forms of scientific enquiry to the commercialization of discoveries. Furthermore there needs to be a way for risk capital to flow to where it can join the opportunities. So too there needs to be a demand for new kinds of output.

All of these requirements call into question the institutions of a society that surround innovation: stock-markets and banking; venture capital; scientific research; intellectual property rights; forms of education; forms of entrepreneurship; market needs and expectations; intermediaries such as R&D firms and incubators; the sharing of knowledge. In firms there is also the crucial question of whether the workforce takes part in the innovative process in partnership with management– as in Japan and Germany or whether it remains relatively uninvolved.

Evidence to date suggests that innovation will remain a serious point of weakness in China that can only be counterbalanced by continued technical borrowing. There are three immediate sources of that weakness: inadequate legal infrastructure; organizational traditions of autocracy and tight control that stifle close manager-worker interdependence; and the scale limitations in small enterprise that stem from mistrust. Lying in the background is the larger question of China's political adjustment to the demands of modernity. Across the variety of modern economies is an array of methods for achieving (i) the stable decentralization of authority that fosters the release of individual initiative and (ii) the capacity for widespread and intensive cooperation in conditions of trust. Without these complex societal achievements incomes per capita above US$40,000 are impossible to achieve, at least on the evidence to date. Our first question is therefore:

***How will China structure its society so as to release the creativity of people and the cooperativeness between them at other than the level of SME entrepreneurship with borrowed technology that has been the leading basis so far?***

**Adaptivenes**

In a fast-changing world societies need themselves to change and China is the ultimate object-lesson in how this may be achieved. Its record here in the past thirty years is astonishing given the scale of things it has to contend with. But so far the adjustments and experiments have rested on the slack we talked of earlier, and in the future it is predictable that much more difficult adjustments may loom. They stem from the nature of world market competition and the intensity with which business now has to battle managerially.

One of these issues has been the subject of a long series of studies by Nolan (2001) examining the condition of the large enterprises controlled by the state, and since the mid 1990's being put through intense pressures to raise productivity. The adaptiveness required here is organizational and the issue is such a challenge because the world of global organizations has itself been through a turmoil of organizational change responding to the new world of information technology. Management in the classic MNE is now unrecognizable from its earlier forms. International teams, virtual organizations, multi-tasking, project structures, flatter hierarchies, intense performance drives and applied rationality, downsizing, delayering, outsourcing, the list reflects a new world. Our second question is:

***Can the large Chinese organization join this world and escape from its traditionally hierarchical structures to encourage widespread participation, or find a formula with equivalent beneficial effects in performance?***

**Efficiency**
A high efficiency economy gets the maximum out of its human, financial, knowledge, and technical assets. It can only do this if it solves two core problems: releasing human creativity and motivation to the highest levels; and fostering intense cooperation and exchange at low transaction costs. We have indicated earlier how this has been done to date in China, and we acknowledge the achievement as formidable. The issue looking forward is what to do for an encore, and especially with regard to the employment of people.

The highest productivity in China is associated with the entrepreneurial private sector and its close collaboration with global markets via OEM in 'the workshop of the world'. Following closely are the local corporates, many based on assets acquired serendipitously in the 'golden years' of the 1990s when the collectives were up for grabs. Efficiency in the state sector remains work-in-progress as suggested above.

Whatever sector takes the lead in moving future productivity to higher levels the core societal issues will need to be faced of fostering individual initiative, creativity and commitment, and in parallel building the quality of societal trust to raise the density of economic exchange. This latter may not be just in trading goods and services, but also in trading cooperation in a boss-subordinate relationship.

In most societies that have trodden this path two things have flowed together. One is the rise of a 'bourgeois' consciousness that permits the evolution of civil society. In turn the latter then induces spontaneous forms of order such as societies, professions, forms of voluntary association, all capable of widening the circles of trust. The second feature is the decentralization of political power and eventually—in most cases—individual voting rights over national issues. This process of individuation brings into being a new psychology that enhances the sense of community and sponsors (with the help of other features) personal initiative.

It would be against the spirit of our general theory to suggest that China has to follow the paths of other societies towards full market-based democracy. Its deeply embedded history and culture would make that surprising. But it is legitimate to ask how China might face the universally applicable questions in its own way. So our final question is:

***If efficiency rests on the furthering of innovativeness and cooperativeness, how will China encourage the emergence of those responses that move it towards these ends in the economic sphere?***

## REFERENCES


Beinhocker, E. D. (2005) *The origin of wealth: Evolution, complexity, and the radical remaking of economics*. London: Random House.

Berger, P. L. and Luckmann, T. (1966) *The social construction of reality: A treatise in the sociology of knowledge*. Garden City, NY: Doubleday.

Johnson, C. (1982) *MITI and the Japanese miracle: The growth of industrial policy 1925-1975*. Stanford, CA: Stanford University Press.

Nolan, P. (2001) *China and the global business revolution*. New York: Palgrave.

OECD (2005) *OECD economic surveys: China*. Paris: OECD.

Podolny, J. M. and Page, K. L. (1998) 'Network forms of organization'. *Annual Review of Sociology, 24*: 57-76.

Redding, G. (2005) 'The thick description and comparison of societal systems of capitalism'. *Journal of International Business Studies, 36*: 123-55.

Redding, G. and Witt, M. A. (2007) *The future of Chinese capitalism: Choices and chances*. Oxford, UK: Oxford University Press.

Tsai, K. S. (2007) *Capitalism without democracy: The private sector in contemporary China*. Ithaca, NY: Cornell University Press.

Whitley, R. (1999) *Divergent capitalisms: The social structuring and change of business systems*. Oxford, UK: Oxford University Press.

Witt, M. A. and Lewin, A. Y. (2004) 'Dynamics of institutional change: Institutional stickiness and the logic of individual action', INSEAD Working Paper Series No. 2004/87/ABCM/EARC 9, Fontainebleau: INSEAD.

Witt, M. A. and Redding, G. (2009a) 'Culture, meaning, and institutions: Executive rationale in Germany and Japan'. *Journal of International Business Studies*, *40*: 859-85.

Witt, M. A. and Redding, G. (2009b) 'The spirits of capitalism: German, Japanese, and US senior executive perceptions of why firms exist', INSEAD Working Paper Series No. 2009/61/EPS/EFE, Fontainebleau: INSEAD.

Europe Campus
Boulevard de Constance
77305 Fontainebleau Cedex, France
Tel: +33 (0)1 60 72 40 00
Fax: +33 (0)1 60 74 55 00/01

Asia Campus
1 Ayer Rajah Avenue, Singapore 138676
Tel: +65 67 99 53 88
Fax: +65 67 99 53 99

www.insead.edu

Printed by INSEAD

INSEAD

The Business School
for the World®