Relational Governance and Transactions
A building block of China's informal economic institutions*
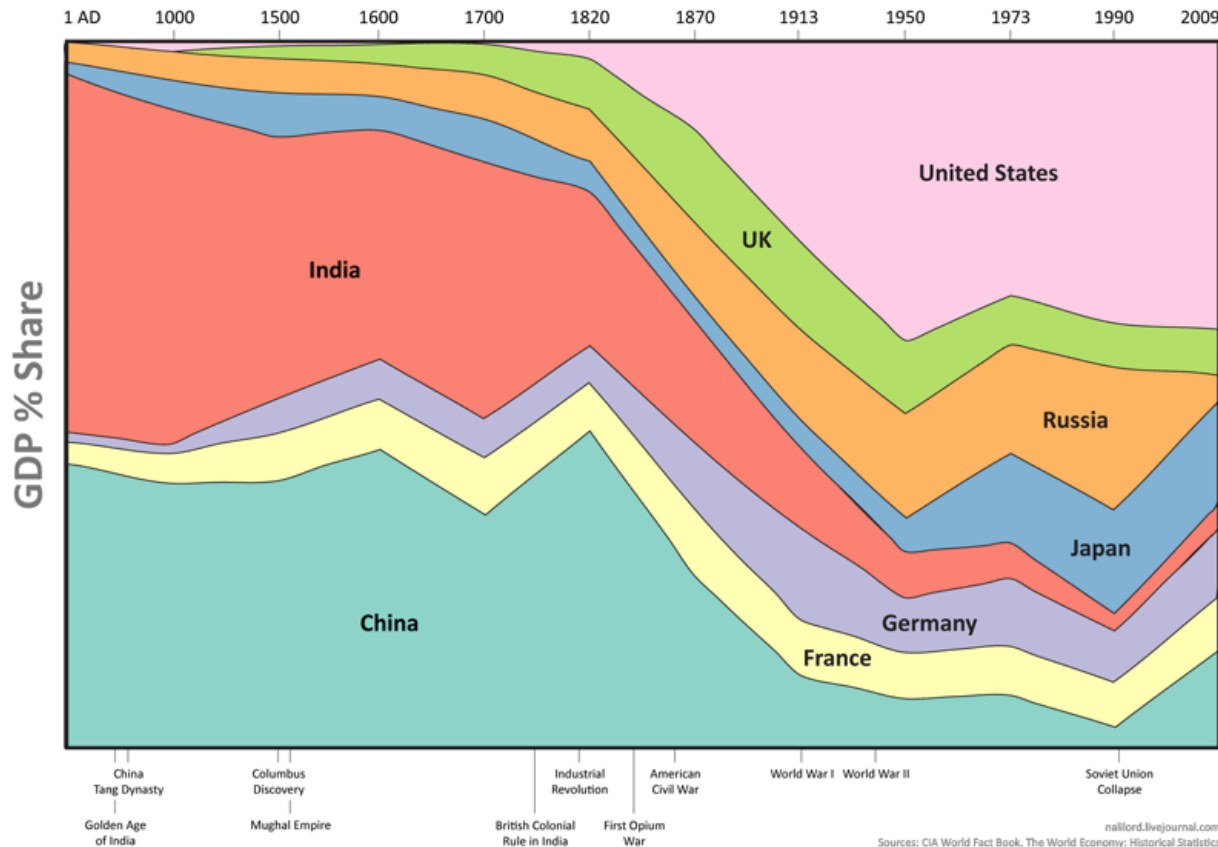
Frieder Munk | Sommerkolloquium des Kooperatives Promotionskolleg der HTWG Konstanz
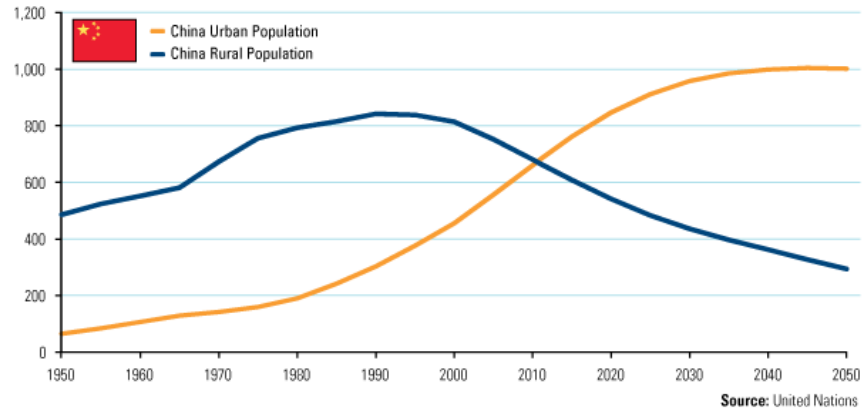
July 5, 2018

1 Economic Environment

GDP Statistics

1 Economic Environment

The rural-urban gap

Urban and rural population projection in millions

Source: United Nations

Urban Income Exceeding Rural Income in China

Source: CEIC and BCA Research

GDP per person, 2012, $'000

1-4 4-7 7-10 10-13 13-16

NATIONAL AVERAGE = **6.1**

Population, 2011, %

Rural, living where registered   Registered urban

Urban, with rural status†

NATIONAL AVERAGE

48.2   35.3

16.5
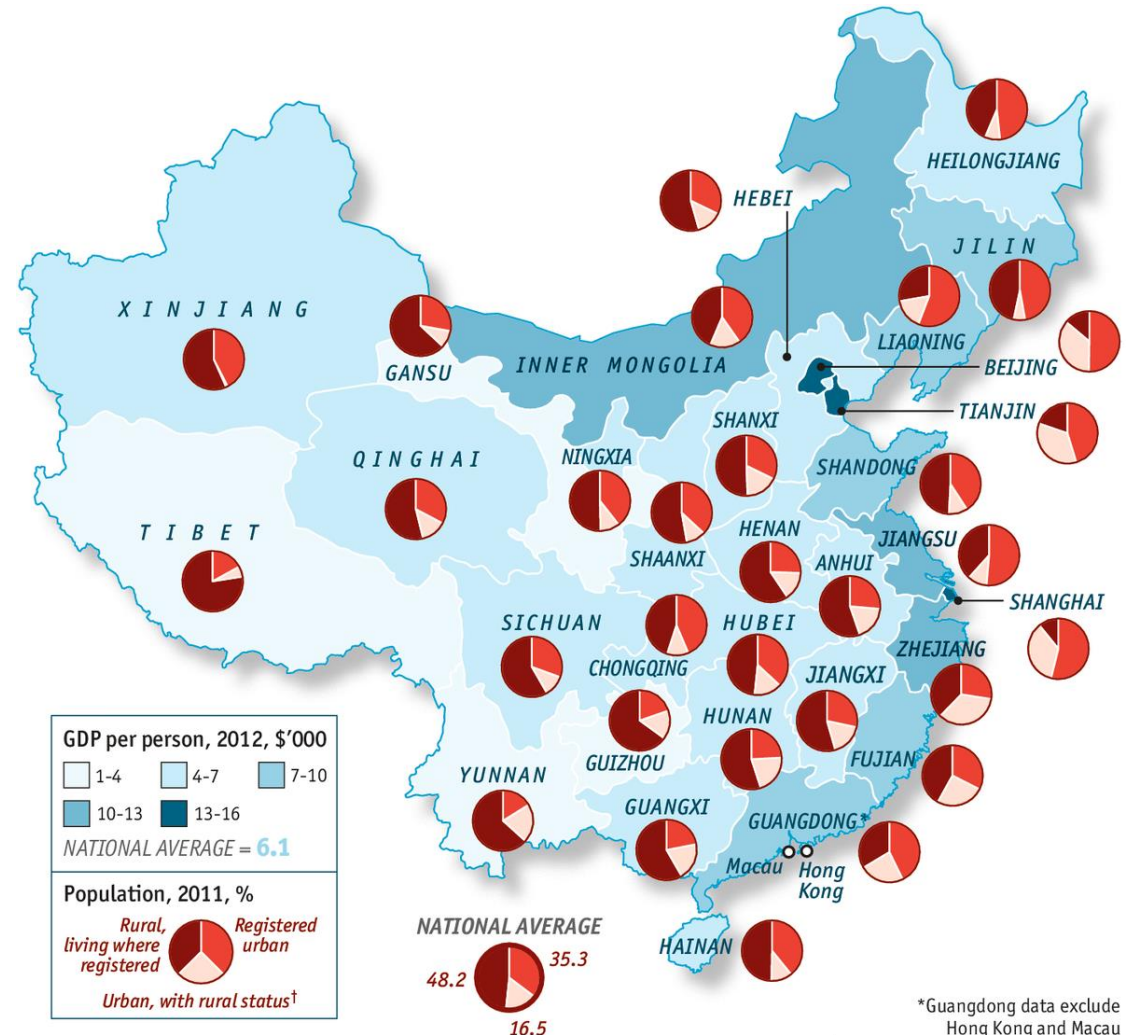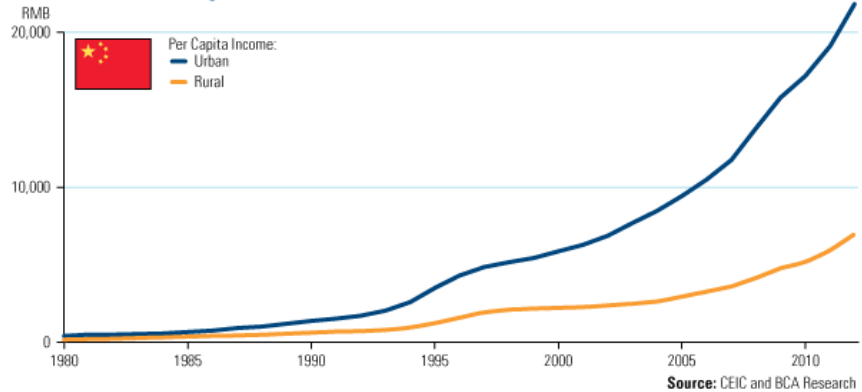
Sources: Haver Analytics; *The Economist* estimates

*Guangdong data exclude Hong Kong and Macau
†Registered as rural, living elsewhere

1 Economic Environment

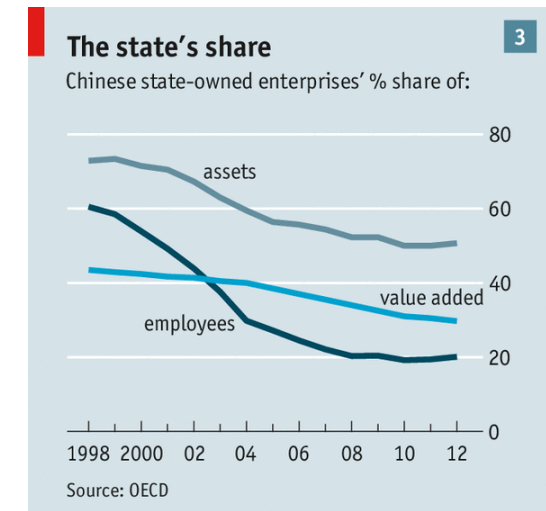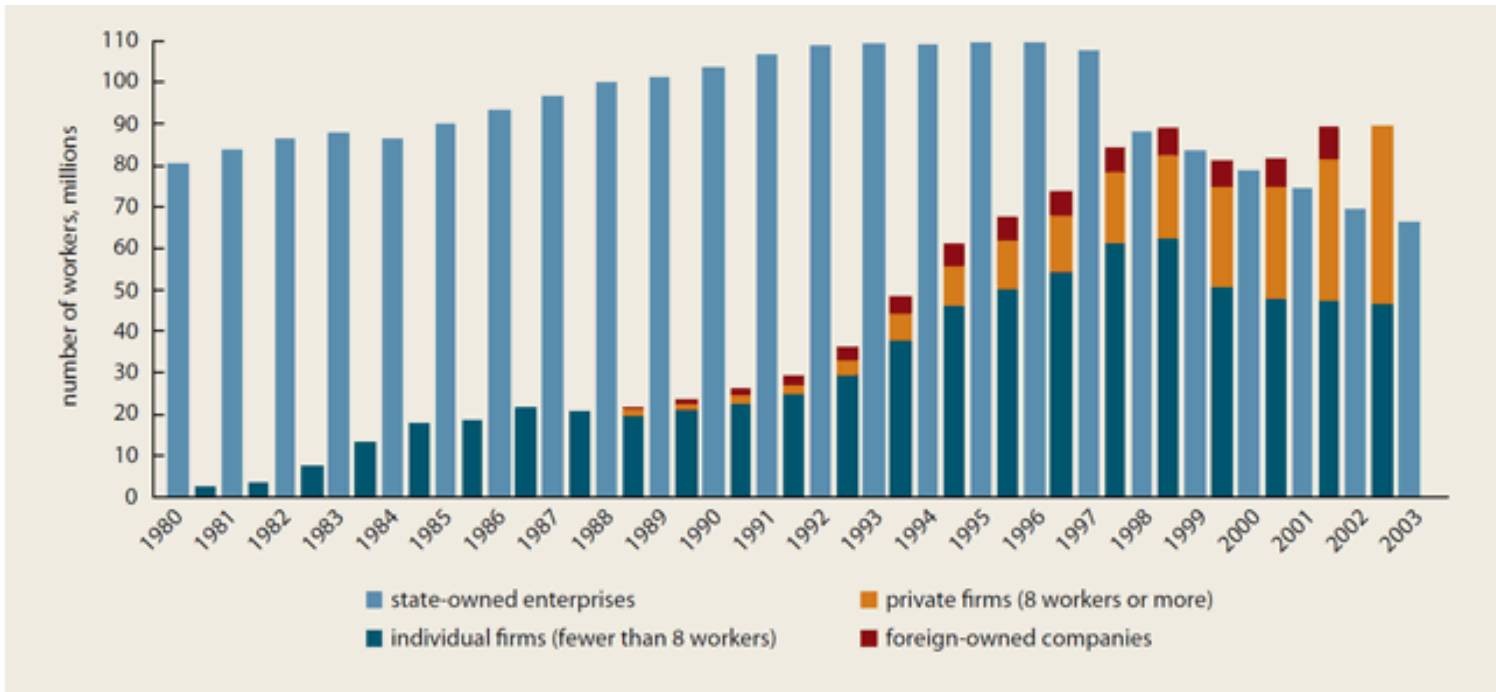| year	The long road to a private-sector economy: China's slow transition
1949 - 1987	Illegal status of private enterprises, only state-owned enterprises (SOEs) allowed
1976 - 1980	After Mao Zedong's death, Deng Xiaoping starts de-ideologisation and begins to „seek truth in facts", travels through the country and opens special economic zones → famous *cat phrase*
1988	Legal status for private firms in the „Temporary regulations of private enterprise" (constitutional amendment of the People's Republic of China, Article 11)
1989 - 1996	Contain private economy as peripheral, subordinate to SOEs (high entry barriers and tax rates, no tax exemptions, lack of governmental start-up capital and bank loans, no export licences, no travel approval, no access to production material and qualified staff, arbitrary local fees)
1997	Jiang Zemin: „State-owned assets or property must continue to hold a position of advantage or superiority […] with regard to the key sector and key spheres"
2004	Formal equality of private sector with SOEs (constitutional amendment)
2007	China Property Rights Law enacted

1 Economic Environment

Early success of China's private sector?

Source: Kanamori and Zhao 2004.
Note: Data for foreign-owned companies in 2002 and for non-state-owned enterprises in 2003 are not available.

Firm advance
China's industrial enterprises*, '000
Total
of which: private
Source: China Macro Finance   *Revenues over 5m yuan

The state's share
Chinese state-owned enterprises' % share of:
assets
value added
employees
Source: OECD

2 Research Framework

Theoretical Setting:

a) New Institutional Economics (NIE), Williamson (1985, 1993)

Reintegration of "atmospheric" elements into market-focused neoclassical economic theory.

- **Interactions:** in a network-based society, business transactions are long-term and people-focused.

- **Transaction Costs:** for early entrepreneurs in China, transaction costs and risks were extremely high

- **Uncertainty:** during the 1980s and 1990s, long-standing rules of China's economy were radically altered

  - Incomplete Contracts: supplier contracts with risk of nondelivery, implicit job contracts (people were working for legally 'forbidden' companies), etc.

  - Asymmetric Information: many entrepreneurs in China had to start their businesses with large knowledge deficits

  - Bounded Rationality: in a rapidly changing economic environment with an unclear legal status of one's economic activities, one has to act according to the principle of bounded rationality.

2 Research Framework

b) Institutional Innovation in China, V. Nee (1992, 1996, 2000), Nee/Opper (2012)

- **Emergence** of a market society in China

- **New institutionalisms** in economics and society

- **Theory of market transition:** from redistribution to markets in state socialism

- **Endogeneous factors** of non-state economic institutions

c) Governance Structure / Governance Ethics, J. Wieland (1996, 1999, 2001)

- **Allocation of moral and status goods** in economic transactions, triadic transformation

- **Microanalytical view of moral dimension** of economic activities (transaction-based analysis)

- **Focus on organizations** and emphasis of cooperation

- **Polylingual and transcultural** approaches

3 Institutional Change in China
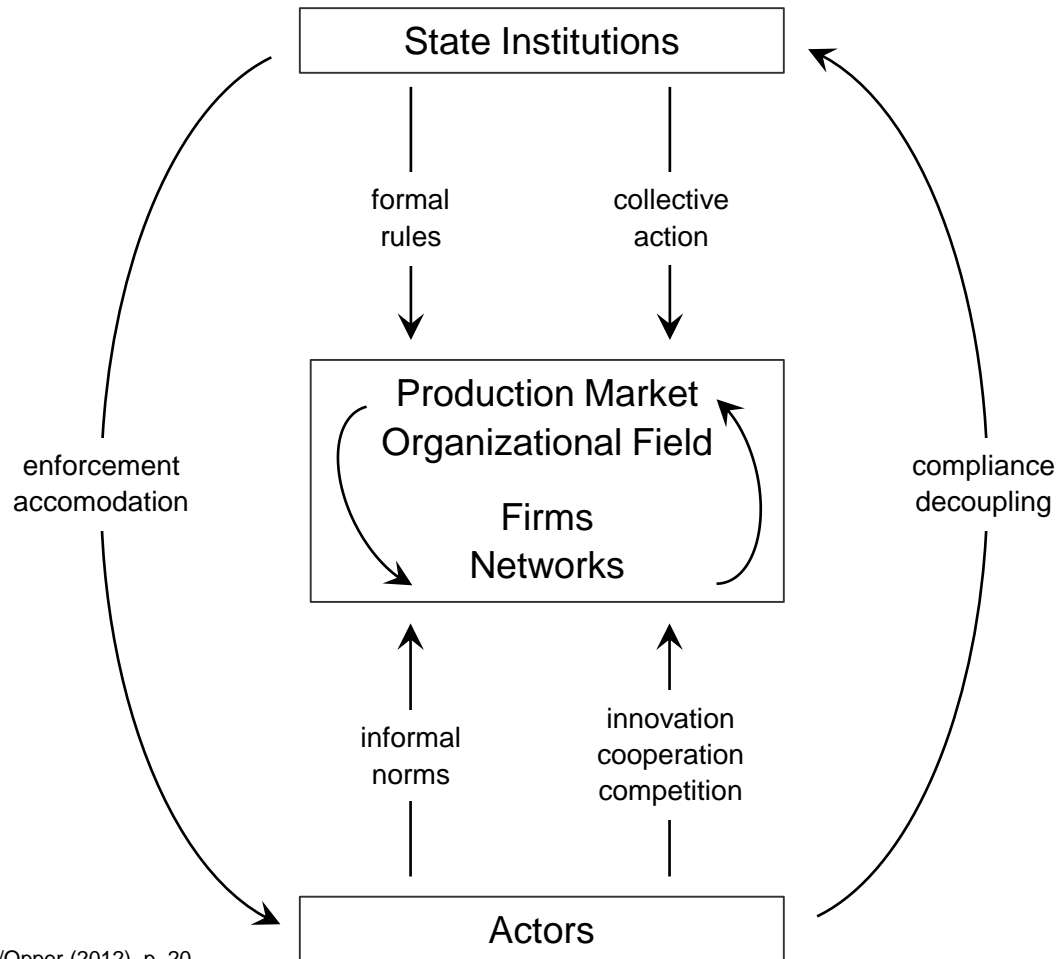
Nee/Opper (2012), p. 20

Explain:

- incentives for joint value creation

- safeguards to reduce uncertainty

- informal collective actors

4 Relational Governance Regimes

What is „relational"?

A) Contracts? → Legal perspective (e.g. Macneil, 1980; Roehrich et al, 2002)

B) Cooperation/Transactions? → Economic perspective (e.g. Dyer and Singh, 1998;

C) Regions/Spatial distribution? → Socio-geographic perspective (e.g. Bathelt and Glückler, 2011)

4 Relational Governance Regimes

A) Sociologists' view on relational governance is to emphasize norms and social behaviour based on earlier transactions

B) Economists focus on the rational, calculative aspects of relational governance: benefits of trustworthiness generated by repeated exchange against the advantages of self-interested actions that conflict with a trustworthy attitude (Poppo and Zenger 2002)

→ cooperative behaviour in the present will be rewarded by the pay-offs of cooperative behaviour in the future
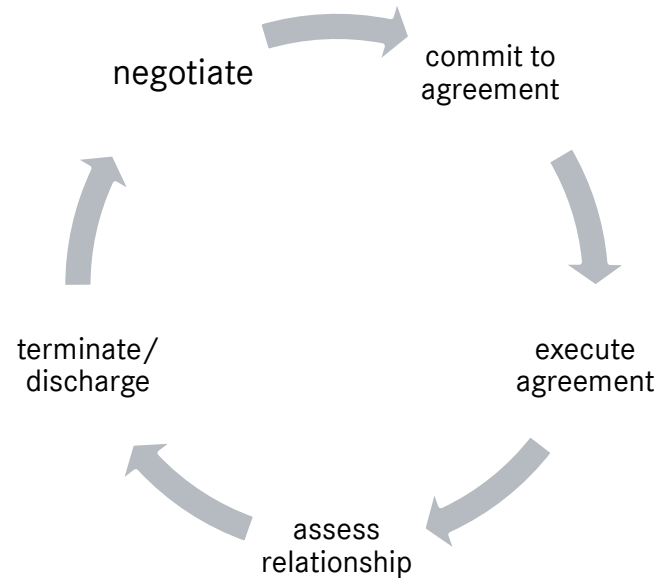
4 Relational Governance Regimes

Relationship Lifecycle Theory

| Awareness | Exploration | Expansion/ Build-up | Commitment/ Maturity | Decline | Dissolution |

Unit of analysis: organizations (Dwyer et al, 1987)

Relationship Development Theory

negotiate → commit to agreement → execute agreement → assess relationship → terminate/ discharge → negotiate
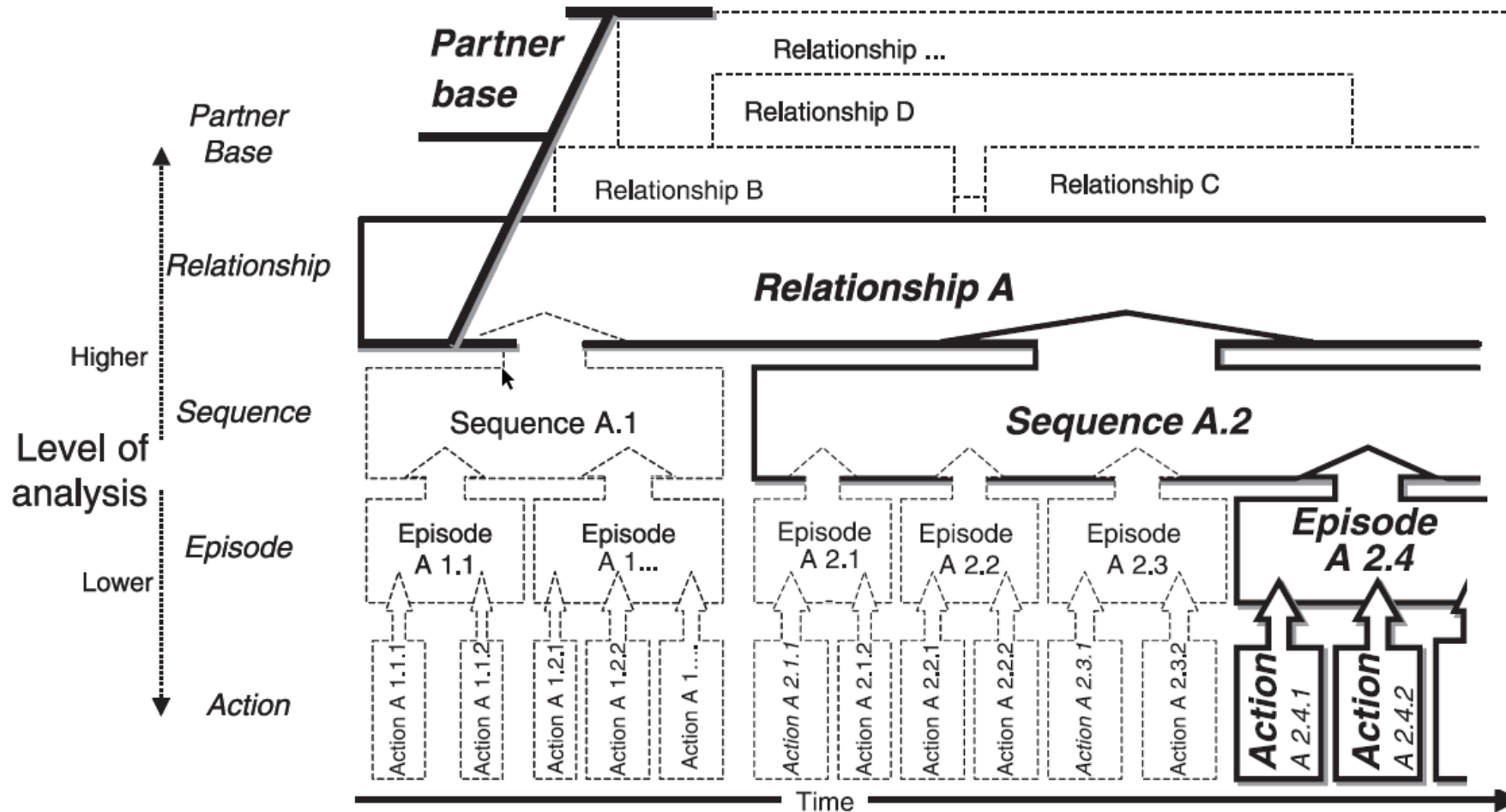
Unit of analysis: individual (Ring and Van de Ven, 1994)

NOTE: the RV cycle happens in every DSO stage!
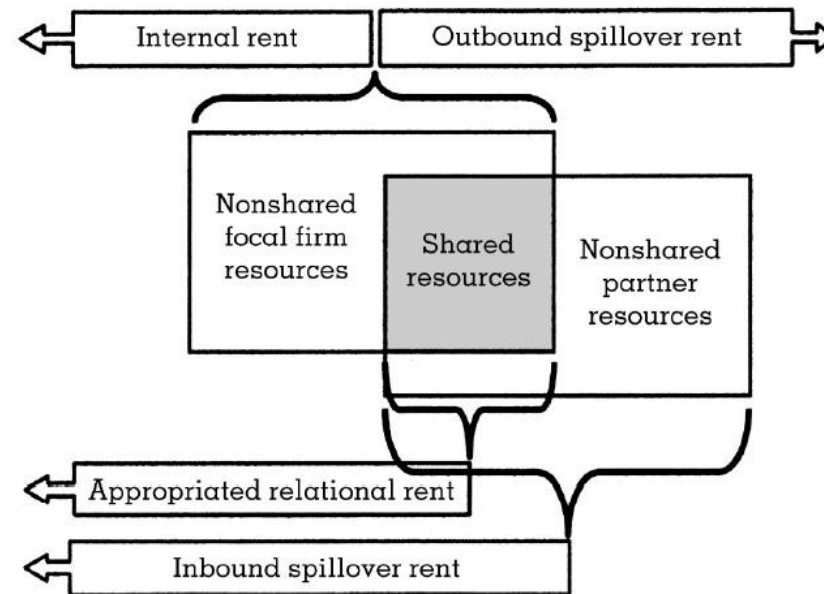
4 Relational Governance Regimes

adapted from Holmlund, 2004

4 Relational Governance Regimes

Competitive advantage:

- Industry structure with entry barriers, technology advances, relative bargainig power etc. (Porter 1980)

- Value-creating/unique resources (Rumelt, 1984; Wernerfelt, 1984; Barney, 1991) → within organizational boundaries

Cooperation: focus on dyads and networks: **relational rents** → extend RBV to include external resources

adapted from Lavie, 2006

4 Relational Governance Regimes

Four Key Determinants (Dyer and Singh, 1998)

1) Relation-specific assets

- site specificity (find close locations to increase joint value generation)

- physical asset specificity (create and utilize assets for a specific relationship)

- human asset specificity (foster long-standing personal relationships between cooperation partners)

2) Knowledge sharing

- interorganisational learning

- tacit know–how versus neutral information

- overlapping knowledge bases and interaction routines

Further determinants: length of the safeguard (lifetime careers, status) and volume of exchange (high-volume deals)

4 Relational Governance Regimes

Four Key Determinants (Dyer and Singh, 1998)

3) Complementary resources

- Strategic resources (prior alliance experience, specific department for cooperations, strong network positions)

- organizational resources (compatibility in decision-making processes, information and control systems or corporate culture)

4) Effective governance

- Third-party enforcement (Formal contracts, means of dispute resolution using the authority of a third-party enforcer)

- Self-enforcing agreements (social constructs: embeddedness, reputation, flexibility, solidarity)

4 Relational Governance Regimes

"Firms who combine resources in unique ways may realize an advantage over competing firms who are unable or unwilling to do so." (Dyer and Singh, 1998)

"[Relational Governance] emerges from the values and agreed-upon processes found in social relationships, which may minimize transaction costs as compared to formal contracts" (Poppo and Zenger 2002, p709).

4 Relational Governance Regimes
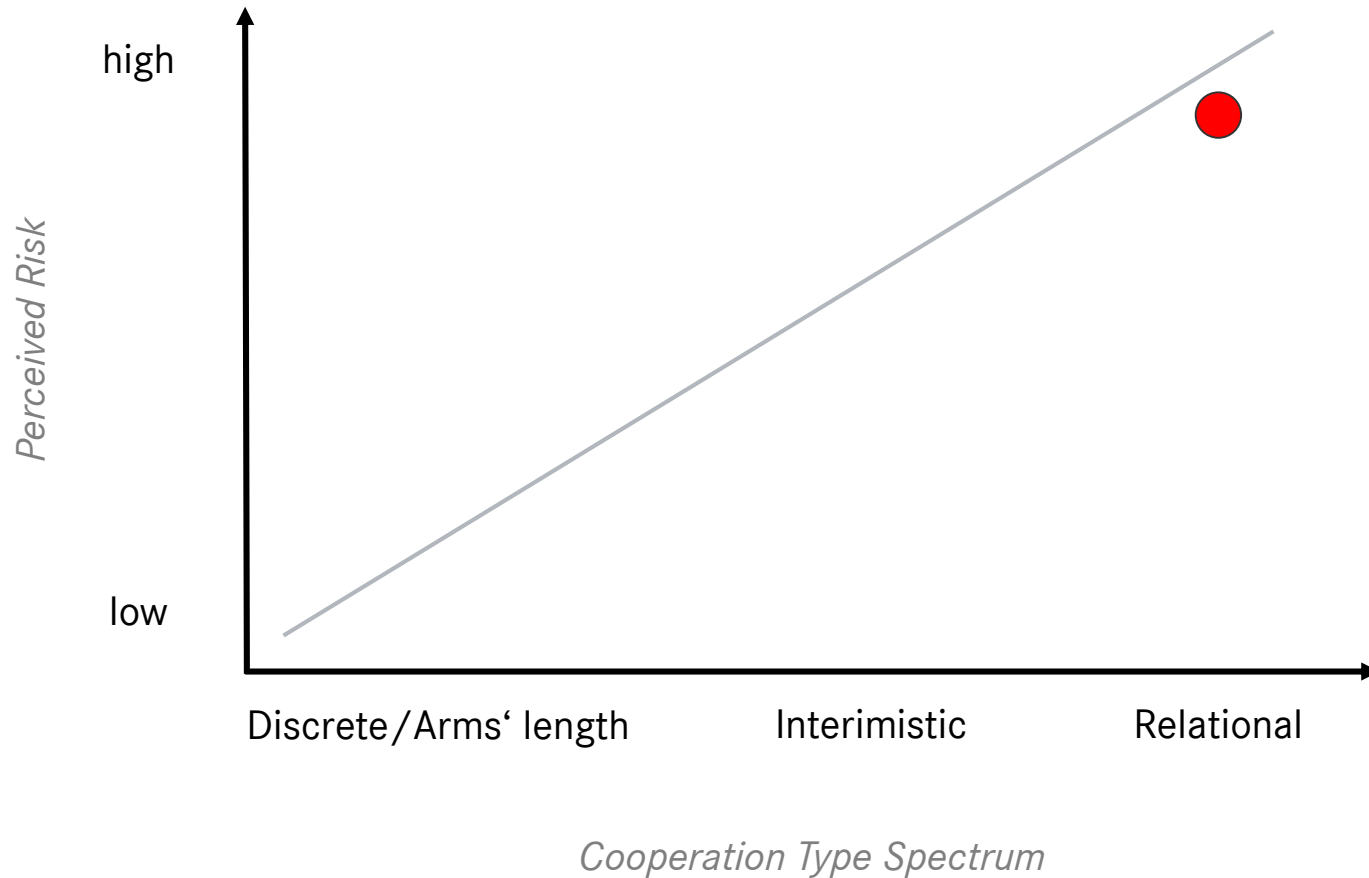
Early entrepreurial cooperations in China

- high specific asset investments
- a strong need for information exchange
- difficulties to switch transaction partners
- overall high level transaction cost

adapted from Macneil, 1980; Chelaria and Sangtani, 2009

4 Relational Governance Regimes

Exchange relationships at the relational end of the Cooperation Type Spectrum (see previous slide) are especially relevant for in markets with

- high specific asset investments

- a strong need for information exchange

- difficulties to switch transaction partners

- overall high level transaction cost

Firms in China's transition economy act under high uncertainty and within a limited set of transaction partners; transaction cost are high and large investments in terms of transaction length and volume are common.

The solidarity aspects of relational governance boost the durability of exchange relations; also the formal contract-based regime can be improved by relational governance due to mutual learning, iterations, and refinement: relational exchanges gradually develop more complex formal contracts. (Example: cooperation partner contract has been refined after a series of experiences made under the relational governance regime)

5 Informal Collective Actors

Patronage networks (PN) – enabling entrepreneurial activity via public-private relational rents (Hillman, 2014)

1) Relation-specific assets for PN

- close neighborhood, town/county-level

- long-term human assets (life-time assignments)

- native place ties, shared professional experience in army or bureaucracy, school ties, complementary business interests

2) Knowledge sharing in PN

- Use of privileged information (prepare for township/county initiatives)

- Insider tips to secure grants and gain control of state subsidies

4 Relational Governance Regimes

Patronage networks: enabling entrepreneurial activity via public-private relational rents (Hillman, 2014)

3) Complimentary resources within PN:

- planning bureau/convert farmland → police force/expel population → real estate development

- Media outlet → Newspaper/magazine licences

- Government grants → infrastructure/tourism projects → construction/forestry works

4) Effective governance of PN

Norms-based governance: moral reasoning to justify patronage network activities (towards others but also towards themselves). Dual effect

a) the public regards these activities as contributing to society and enables them to stay in power and achieve acceptance for further transactions.

b) successful transactions elevate the **status** of both clients and patrons, which is necessary to increase their power and create opportunities for promotion and career advancement (see also: Herrmann-Pillath, 2015)
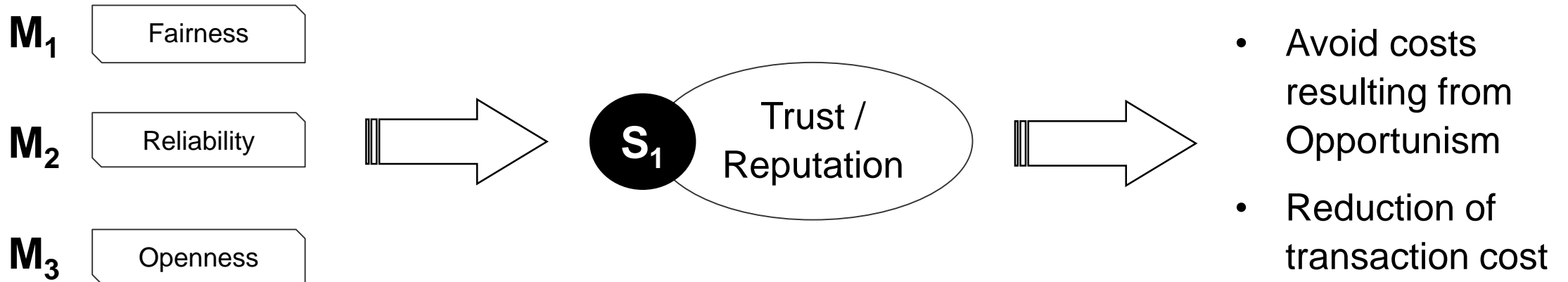
6 Allocation of moral and status goods

Moral goods: non-marketable elements of implicit contracts. They are docked at/crystallized with economic goods.
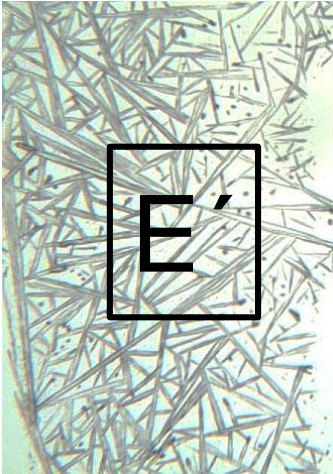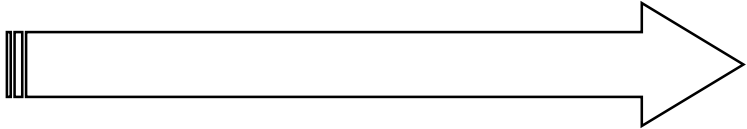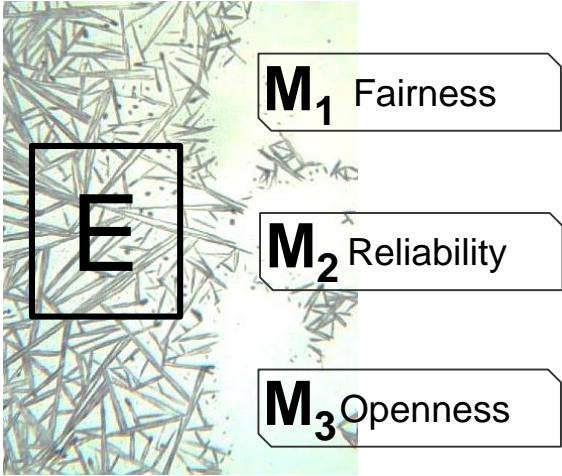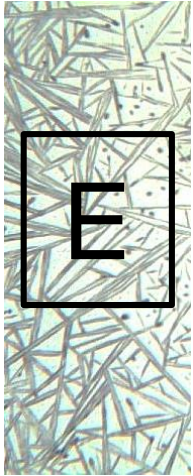
Status goods: reputational function/ascribe characteristics which symolise regard/disregard.

→ Moral goods allocate status goods which in turn leads to economic consequences. (Wieland 1996)

→ The MSE (moral-status-economic) triad is a transcultural concept which is determined by context-specific factors.
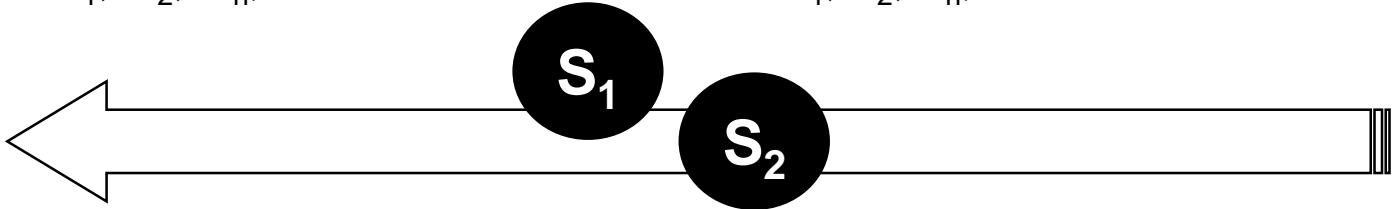
M_1 Fairness

M_2 Reliability

M_3 Openness

S_1 Trust / Reputation

- Avoid costs resulting from Opportunism

- Reduction of transaction cost

6 Allocation of moral and status goods

Crystallisation of
moral goods
M_1, M_2, M_n, …

Co-allocation of
status goods
S_1, S_2, S_n, …

Actor A

Actor B

7 Networks and Cooperation

"Like all other organizations networks always form hierarchies, but the ability of an actor to cooperate independently and decentrally must also be inherent to the system. It is precisely this latter aspect of interaction on which the idea of the networks is based; in this world social, moral and other informal resources of the actors become more important." (Wieland 2014, p201)

→ Amount of network nodes as an increasingly important status good?