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## Government and family guanxi in Chinese private enterprises

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### Abstract

Domestic private enterprises have dramatically re-emerged in China's unique transition from a planned to a market-oriented economy, where the private sector plays an increasingly important role. Over the last quarter of a century, there has been a decline in 'red-hat' enterprises and an increased dominance of family businesses among private enterprises. This paper employs the concept of trust, which stems from traditional culture and comprises two important components (government and family), to investigate the changing patterns of corporate governance. The core argument of this paper is that family trust is replacing government trust within Chinese private enterprises. The study of the determinants of government and family trust (Guanxi) of this paper is based on a survey conducted in 2006 over 296 private enterprises in Ningbo China. The empirical results show that private firms prefer family members to the government for co-operation as the firm ages and the instability of the business environment increases. The findings of this paper give additional support to our understanding of why family businesses constitute the majority of Chinese private firms. The results also reflect the different effects of government and family Guanxi on the firm's economic activities, representing respectively the separation or combination of ownership and control in terms of corporate governance in private firms.

### Keywords

Government, family, guanxi, Chinese, private, enterprises

### Disciplines

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# **Government and Family *Guanxi***

## **in Chinese Private Enterprises**

--Theoretical Consideration and Empirical Investigation

**Abstract** Domestic private enterprises have dramatically re-emerged in China's unique transition from a planned to a market-oriented economy, where the private sector plays an increasingly important role. Over the last quarter of a century, there has been a decline in 'red-hat' enterprises and an increased dominance of family businesses among private enterprises. This paper employs the concept of trust (*Guanxi* in Chinese), which stems from traditional culture and comprises two important components (government and family), to investigate the changing patterns of corporate governance. While both government and family *Guanxi* have played an important role in the development of Chinese private enterprises, there is a distinction between government and family *Guanxi* within private enterprises in terms of corporate governance. The core argument of this paper is that family *Guanxi* is replacing government *Guanxi* within Chinese private enterprises. The empirical study of the determinants of government and family *Guanxi* of this paper is based on a survey conducted in 2006 over 296 private enterprises in Ningbo China.

**Key words:** *Guanxi*, government and family, corporate governance, private enterprises in China

**JEL classification:** G30, L20, M20

## 1 Introduction

Domestic private enterprises have dramatically re-emerged in China's unique transition from a planned to a market-oriented economy since the late 1970s, where the private sector plays an increasingly important role. Initially permitted only on the fringes of the economy, the domestic private sector was estimated to account for about one-quarter of gross domestic product (GDP) in 2005 (Yearbook of State's Industrial and Commercial Administration, 2005). Between 1990 and 2004, private sector employment increased by 322% from 22.74 million persons to 96.04 million persons. During the same period, private sector output grew in real terms from RMB76.4 billion to RMB1478.5 billion (1990 price), with an average annual growth rate of 23.57%.<sup>1</sup>

The pattern of private sector development has differed across regions. For instance, in southern Jiangsu province, many private enterprises are spin-offs from state and collective enterprises ('the Sunan model'). In the Pearl River Delta region of Guangdong province, private enterprises are often supported by capital from Hong Kong, Macao and other developed economies ('the Guangdong model'). In Zhejiang province, the establishment and expansion of many private enterprises have relied on capital accumulated by their resident owners through savings and retained earnings ('the Zhejiang model'). This paper focuses on the pattern of private sector development characterised by the Zhejiang model.

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<sup>1</sup> Calculations based on data from Statistical Year Book of China 1990-2005 and Yearbook of State's Industrial and Commercial Administration, 1991-2005.

Following two decades of development, Zhejiang has stayed at the forefront of private enterprise development in China, strongly contributing to the provincial economy. The share of GDP produced by domestic private enterprises reached 55.1% of the provincial total in 2004 (Zhejiang Statistical Yearbook, 2005). Between 1990 and 2004, total output of private enterprises increased from RMB 14.1 billion to RMB 471.9 billion (1990 price), with an average annual growth of 28.5% in real terms. During the same period, private sector retail sales grew at an average annual rate of 24.9%, and tax revenue from private enterprises grew at an average annual rate of 23.5%. Zhejiang ranked first nationwide in terms of absolute numbers in each of these indicators over seven years from 1998 to 2004 (Report of China's Citizen-run Enterprises, No.2, 2004, p.182). The average annual growth rates in Zhejiang for these three indicators are higher than the corresponding national average annual growth rates during the same period at 4.9%, 7.7%, and 4.5%, respectively (Report of China's Citizen-run Enterprises, 2004).

Since their re-emergence, the development of Zhejiang private enterprises has been characterised by two main institutional features. One is the significant involvement of local governments in the firm's economic activities. From the firm's perspective, local government involvement serves to avoid government predation and ideological harassment, and facilitates material needs and information for successful production. The important role that the government has played in private enterprise development is represented by the phenomenon of 'red-hat' firms, meaning that a private

enterprise was 'wearing a red hat' to retain an affiliation to an established collectively-owned or state-owned entity in which the government was to mainly serve as protection for burgeoning Zhejiang private enterprises (Sun, 2000). This was commonplace in the 1980s and early 1990s and which shared similarities to the well-known township-village enterprises (TVEs)<sup>2</sup>. The second feature of Zhejiang private enterprises has been the involvement of family members, resulting in the prevalence of family businesses among private enterprises, and it is estimated that about 90% of total private enterprises are family businesses (Blue Book of Private Enterprises, 2001, 2002; Gan, 2002). In fact, there have been almost no 'red-hat' enterprises registered in the recent years, while family businesses are still prevalent and constitute the majority of Zhejiang private enterprises.

Therefore, the evolution of private enterprises in Zhejiang Over the last quarter of a century exhibits an important trend of changing patterns in corporate governance: there has been a decline in 'red-hat' enterprises and an increased dominance of family businesses among private enterprises. How can we explain this phenomenon?

This paper employs the general notion of trust (*Guanxi* in Chinese), which stems from traditional culture and comprises two important components (government and family), to investigate the changing patterns of corporate governance. While presenting two hypotheses pertaining to government and family *Guanxi* in Chinese private

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<sup>2</sup> 'Red-hat' firms referred to private firms that put on a 'hat' of collective ownership to evade the government's prohibition on private firms and associated ideological harassment. According to a spot-check of 178,000 collective enterprises in 16 provinces and 35 cities (counties) by the State Bureau of Industrial and Commercial Administration in 1995, 20.8% of firms were 'fake collectives' because more than 51% of these firms' assets were privately-owned (Report of China's Citizen-Run Enterprises, No.1, 2004, p.180). In the 1980s and first half of the 1990s, most TVEs in the Zhejiang model were 'red-hat' enterprises.

enterprises for theoretical consideration, the empirical study is based on a survey conducted in 2006 over 296 private enterprises in Ningbo, Zhejiang province. The remainder of this paper is organized as follows. Section 2 presents theoretical consideration for the changing patterns of corporate governance in Zhejiang private enterprises, and raises two hypotheses regarding government and family *Guanxi*. Section 3 describes the data and gives the definitions of the variables used in the study, as well as discussing the econometric methodology. Section 4 presents the empirical results pertaining to the determinants of the perceived importance of government and family *Guanxi*. Section 5 discusses the factors which explain firm preference for government or family *Guanxi* in Chinese private enterprises. Conclusions are presented in Section 6.

## **2 Theoretical consideration**

### **2.1 Trust and *Guanxi* in China**

There is no clear definition of trust in the economic literature. Generally, <sup>3</sup>when we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him.’ (Gambetta, 1988, p.217) Trust can be viewed as an expectation, and it pertains to circumstances in which agents take risky actions in environments characterized by uncertainty or informational incompleteness (James, 2002). It is commonly accepted that trust provides a solid foundation for cooperation. Regarding China, *Guanxi* is generally viewed as networks of informal relationships and exchanges of favours that

dominate business activity (Lovett et al., 1999; Li, 2002). In particular, *Guanxi* involves cultivating personal relationships through the exchange of favours and gifts for the purpose of obtaining goods and services, developing networks of mutual dependence, and creating a sense of obligation and indebtedness (Yang, 1994). When discussing the business practices of Chinese private firms, *Guanxi* and trust are interchangeable in much of the literature (Wank, 1996; Xin and Pearce, 1996; Li, 1998; Lovett et al., 1999; Schlevogt, 2001; Sun and Wong, 2002).<sup>3</sup> This paper also treats trust and *Guanxi* as synonymous terms. *Guanxi*, the same as trust, which has deep embeddedness of particular cultures and hence is culturally determined (Granovetter, 1985; Fukuyama, 1995), overreaches the formal organizational structure in many cases in China. *Guanxi* is the most suitable word to capture the various informal business relationships in China (Yang, 1994; Guthrie, 1998).

In our view, two types of *Guanxi* are prevalent in China. One is government *Guanxi* which refers to entrepreneurial ties with officialdom (Wank, 1996). It centres on cultivating personal relationships with government officials (Yang, 1994, 2002; Wank, 1996; Guthrie, 1998), but is different from bribery. Government *Guanxi* places much more emphasis on human feelings, long-term obligations and bonding than the material interest exchanged, whereas with bribery and corruption, the social relationship is a means, not an end, of the exchange. Given this distinction, *Guanxi* is viewed in a positive fashion. The role of government *Guanxi* within Chinese private enterprises is represented by the phenomenon of 'red-hat' enterprises. In this case, the

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<sup>3</sup> For example, Li (1998, p.295) writes 'trust (*guanxi*, in general).'



government is an active participant in the firm's economic activities, which provides the advantage of avoiding government predation and ideological harassment, especially in the early development stages. In addition, in an imperfect institutional environment such as China, where many exchange relationships are personalized and access to market information and scarce inputs is a matter of privilege, government *Guanxi* can be represented by procurement ability, which is essential for successful production (Tian, 2000). Another type of *Guanxi* is family *Guanxi*, which refers to the trusting relationship between family members and friends. In China, family ties are substantially strengthened by Confucianism. There is much emphasis on family-based relations and respect for collective orientation in private enterprises (Schlevogt, 2001). Thus Sun and Wong (2002) argue that trusting relationships between family members underpin the development of private enterprises. Notably, although family *Guanxi* is mostly family centred, it has an extraordinary capacity to extend beyond family members to friends and acquaintances (Sun and Wong, 2002). As a result, family *Guanxi*, like government *Guanxi*, can also be treated as an ability to obtain necessary inputs for successful production that cannot be readily acquired through ordinary market transactions. The important role played by family *Guanxi* is obviously reflected in the dominance of family businesses among Chinese private enterprises, as discussed above.

## **2.2 Distinction between government and family *Guanxi***

While both government and family trust (*Guanxi*) have played an important role in

the development of Chinese private enterprises, differences between them can be located in terms of three important factors of trustworthiness: ability, benevolence, and integrity (Mayer et al., 1995; Lovett et al., 1999). In simple terms, ability refers to competence and expertise, while benevolence refers to loyalty and altruism, and integrity refers to consistency and congruity (Mayer et al., 1995). In terms of ability, although family members have been a major source of cheap and flexible resources for private enterprises (Roberts and Zhou, 2000), their financial competence is limited compared with that of the government in accessing capital, in particular bank loans, which is critical to enterprise development (Sun and Wong, 2002). In this manner, government *Guanxi* can be interpreted as being at a higher level of ability than family *Guanxi*. In terms of benevolence, although the government generally acts as a 'helping hand' in market-oriented reforms (Li, 1998), this does not mean that government policy always gives priority to the long-term development of private enterprises (Sun and Wong, 2002). Rather, new regulations have often been accompanied by 'rectification' campaigns, which have impeded private enterprise development (Gregory et al., 2000). Moreover, there is a tendency for the government to increase rent-seeking in successful enterprises (Sun, 2002; Wang, 2002). In contrast, it is generally accepted that family relationships represent loyalty and altruism simply because family members care more about each other than outsiders (Whyte, 1995; Schlevogt, 2001). In this manner, family *Guanxi* is at a higher level of benevolence than government *Guanxi*. In terms of integrity, it has been argued that private business was experimental during the reform periods (Gelb et al., 1993) and there was no

effective mechanism to ensure that the government could not suddenly reverse the reform process or impose exactions on private enterprises (Li, 2004), while the success of family firms lies in the stability of the family system (James, 1999; Leung, 2000). In this respect, family *Guanxi* represents a higher level of integrity than government *Guanxi*. To sum up, among the three aspects of trustworthiness, government *Guanxi* generally represents a higher level of ability, while family *Guanxi* generally represents a higher level of benevolence and integrity within private enterprises.

More importantly, as noted by North (1990, p.37), since governmental institutional arrangements rest on the 'coercive' power of government, they stand on a somewhat different footing than individual and voluntary organization.' Therefore, government and family *Guanxi* have different effects on corporate governance of private enterprises. The control rights within a 'red-hat' enterprise rest with both the manager and the government (Smyth, 1997; Hsiao et al., 1998),<sup>4</sup> or the government only (Weitman and Xu, 1994; Chang and Wang, 1994; Che and Qian, 1998). Consequently, the government shares the profits with investors (Pearce, 2001; Rao et al., 2005). However, the conflicts of objectives and interests between the firm and the government are obvious because local governments are not purely economic actors but pursue multiple social, political and economic objectives such as employment maximization (Bowles and Yong, 1999; Sun, 2002). As a consequence, private

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<sup>4</sup> For example, Smyth (1997) argues that the control rights of a TVE shift from the township-village government to the managers and skilled workers. This indicates that the government has the rights to control the firm.

enterprises often go along with government interference, which often contradicts their interests (Sun and Wong, 2002). In fact, there is a tendency for local governments to misuse their ownership rights over 'red-hat' enterprises (Sun, 2002). In this manner, corporate governance in a 'red-hat' enterprise can be interpreted as separation of ownership and control. In contrast, within a typical family business, control rights are in the hands of the owner, who is also the manager of the firm (Schlevogt, 2001). In other words, this kind of firm can be viewed as an owner-cum-manager firm (Fama and Jensen, 1983; James, 1999). Moreover, often the investor is also the owner of the firm. In this sense, the management of a family business is called 'three roles in one' management (the investor, the owner, and the manager) or 'four roles in one' (adding the producer) in some of the literature (Blue Book of Private Enterprises, 2001, 2002; Gan, 2002), i.e., non-separation of ownership and control.

### **2.3 Two hypotheses**

Although it is difficult to measure the quality of economic environment and more difficult to measure its change in relatively short period of time, it is commonly acknowledged that the business environment in a developing market such as China is more volatile relative to many developed markets. As noted by Singh (2003, p.459), in broad terms developing markets are essentially characterized by 'pervasive and inefficient government control [of] economic activity, lack of competition, [and] immature and imperfect capital markets' and hence it is expected that there will be a relatively volatile business environment. Fligstein (1996) argues that an ineffective or non-facilitative government such as in many developing countries creates an

environment characteri]ed by greater uncertainty, and more political and financial risk for independent organi]ations. In these circumstances, *Guanxi* can be used to reduce the transaction costs associated with environmental uncertainties and to improve efficiency (Lovett et al., 1999; Standifird and Marshall, 2000), particularly in a situation where the hapha]ard enforcement of laws by state agents is a major source of uncertainty (Wank, 1996). Greater business instability seems to be associated with greater need for both government *Guanxi* (Seace, 2001; Rao et al., 2005) and family *Guanxi* (Leung, 2000; Schlevogt, 2001). Following these arguments, we have the first hypothesis regarding government and family *Guanxi*:

***Hypothesis 1: Both government and family Guanxi are viewed as important by Chinese private enterprises in the volatile business environment.***

Following the argument by Weit]man and Xu (1994) that cooperative culture strongly influences the development of Chinese enterprises, the 'red-hat' firms and family businesses in the Zhejiang model represent respectively the cooperation with government and family *Guanxi*. As discussed above, government and family *Guanxi* have different effects on corporate governance of private enterprises, representing respectively separation or non-separation of ownership and control. According to agency theory, the agency problem arises in corporate governance if there is a conflict of interests between the owners/shareholders (the principal) and the manager (the agent). Since management has the right of control, it can act against the interest of owners. The agency problem can be mitigated at a cost, which include the cost of

monitoring incurred by the principal, bonding expenditures incurred by the agent (to guarantee that the agent will not take actions to harm the principal), and the value of the lost residual borne by the principal (Jensen and Meckling, 1976). To mitigate the problem of agency, an obvious remedy is to increase management shareholding, making the manager a significant residual claimant. In development of private enterprises in Zhejiang, family ownership and reliance on family connections may have been considered to be a way of mitigating agency costs as conflict of interests are less likely or less severe, and monitoring and bonding costs are likely to be lower.

On the other hand, the importance of family *Guanxi* has its origins in Adam Smith's conception of self-interest as a means of explaining the way people behave: 'every man « is first and principally recommended to his own care ... after himself, the members of his own family « are naturally the objectives of his warmest affections. They are naturally and usually the persons upon whose happiness or misery his conduct must have the greatest influence.' (Smith, 2002, p.257) In short, there is good reason to believe that feelings of family members are stronger than that of others outside the family. Corresponding to the changing patterns in corporate governance in Zhejiang private enterprises as discussed above, we have the second hypothesis regarding government and family *Guanxi*:

***Hypothesis 2: Chinese private enterprises prefer family Guanxi over government Guanxi for cooperation.***

The above two hypotheses constitute the core argument of this paper; that is,

although both government and family *Guanxi* are important, family *Guanxi* is replacing government *Guanxi* within Chinese private enterprises. These two hypotheses will be tested below.

### **3 Data Collection, Specification, and Methodology**

#### **3.1 Data collection**

Ningbo is the second largest city in Zhejiang province, where the development of private enterprises corresponds generally with that of private enterprises in the whole of Zhejiang province. The survey was administrated by the first author to private enterprises in Ningbo between ' eember 2005 and February 2006. Altogether 400 copies of questionnaires were distributed to private enterprises, with assistance from the Ningbo's Bureau of Industrial and Commercial Administration and the Association of Ningbo's Private Enterprises. By the end of the survey, 327 copies of the questionnaires had been collected, accounting for 82% of total distributed questionnaires. After removing incomplete questionnaires, there were 296 valid questionnaires, accounting for 91% of total collected copies or 74% of total distributed copies. All valid questionnaires were checked for accuracy twice prior to being entered into a database. The econometric results in this paper are supplemented with findings from a limited number of interviews with firm owners and managers that were conducted at the same time as the survey was administrated.

INSERT TABLE 1

In the sample of 296 firms from which valid results were obtained, five firms were

privatized state-owned enterprises, accounting for 1.7% of the sample and 63 firms had been transformed from collective-owned enterprises, whereby they took off their 'red-hats,' accounting for 1.3% of the sample. The remaining 118 firms were green-field private firms accounting for 77.03% of the sample. Within these 196 private firms, although there were 10 firms with government shares when they started as private businesses, there was no government shareholding in the private enterprises in the sample at the time of the survey. Overall, there were 183 firms where families controlled at least 50% of the shares, accounting for 95.6% of the 196 firms. That is, most private enterprises in the sample were characterized as family businesses. The sector distribution of these 196 firms corresponds with the sector distribution of privately-run enterprises in Ningbo as a whole, as shown in Table 1. Overall, the 196 firms in the survey are generally representative of the basic characteristics of private enterprises in Ningbo.

### 3.2 Empirical specification

We use two ordered logit models to study the determinants of the perceived importance of government and family *Guanxi*, respectively. The models are specified as follows:

$$Gg = \alpha_g + \beta_{1g}Age + \beta_{2g}LnAsset + \beta_{3g}Instability + \beta_{4g}Gift + \mu_g \quad (1a)$$

$$Gf = \alpha_f + \beta_{1f}Age + \beta_{2f}LnAsset + \beta_{3f}Instability + \mu_f \quad (1b)$$

$Gg$  in equation (1a) denotes the private firms' perceived importance of government *Guanxi*, and  $Gf$  in equation (1b) denotes the private firms' perceived importance of



family *Guanxi*.

Following previous studies of the determinants of *Guanxi* by Xin and Pearce (1996) and Lovett et al. (1999), the *explanatory* variables in our empirical models include firm age (*Age*), firm size (*LnAsset*), and the instability of the business environment (*Instability*).<sup>5</sup> In addition, we also include a variable denoting 'gift-giving' (*Gift*) in the first model examining the determinants of government *Guanxi*. We do so because given Chinese *Guanxi*-based business practice has been called 'the gift economy' (Yang, 1994), and gift-giving is critical to building and maintaining relationships with government officials (Wank, 1996). Xin and Pearce (1996) argue that private executives' expectations of cultivating connections with the government will be reflected in their gift-giving patterns, and find that private executives make more extensive use of gift-giving to build connections with the government than executives in state-owned enterprises (SOEs) and collective-owned companies (COEs). For this reason we include the gift-giving variable as a determinant in the first model. In contrast, family *Guanxi*, which is unusually strong and prevalent in Chinese private enterprises (Whyte, 1995; Xing, 1995; Schlevogt, 2001), is not affected by gift-giving patterns. On this basis, the gift-giving variable is included in the government *Guanxi* model, but not in the family *Guanxi* model.

### 3.3 Descriptive statistics

The variables in equation (1a) and (1b) are measured as follows and their descriptive

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<sup>5</sup> Xin and Pearce (1996) examine the determinants of *Guanxi* by controlling for firm age and firm size. Lovett et al. (1999) argue that changes in the business environment represent a determinant of *Guanxi*.

statistics are reported in Table 1.

INSERT TABLE 1

The dependent variables used to explain the perceived importance of government and family *Guanxi* are as follows: *The perceived importance of government Guanxi (Gg)* is measured by a five-point scale with 1= 'not helpful at all,' 2= 'relatively not helpful,' 3= 'neutral,' 4= 'relatively helpful,' 5= 'very helpful.' Similarly, the perceived importance of family *Guanxi (Gf)* is also measured by the same scale. From Table 1, we see that the mean of government and family *Guanxi* were 3.79 and 3.80 respectively, indicating that government and family *Guanxi* were viewed by private firms in the sample as almost of equal importance.

The independent variables are as follows:

1) *Firm age (Age)*. This variable denotes length of time between when the firm registered as a private enterprise and the date of the survey. As shown in Table 1, the average age of firms in the sample was six years at the end of 2004, indicating that most private firms were established after the commencement of ownership reform of COEs and SOEs in 1997, and after the recognition of private enterprises in the Chinese Constitution in 1999.

In the context of *Guanxi*-based business practices in China, Guthrie (1998) and Li (2001) argue that the significance of *Guanxi* is declining due to the development of a rational-legal system and the evolution of increasingly competitive markets (Li, 1998; Gregory et al., 2000; Singh, 2003), seemingly suggesting that the significance of both government and family *Guanxi* has declined in contemporary China. However, our

core argument in this paper suggests that government *Guanxi* is being replaced by family *Guanxi* in private enterprises, implying that the importance of government and family *Guanxi* would be viewed differently by private firms. More precisely, because government connections allowed many firms that were actually private-owned enterprises in Zhejiang province (including Ningbo) to register as 'red-hat' firms in the early reform period, old firms seem more likely to regard government *Guanxi* as more important than young firms. On the other hand, most firms in the sample were family businesses and they were newly-established, which seems to suggest that young firms view the importance of family *Guanxi* as more important than old firms.

(i) *Firm size (LnAsset)*. This variable is measured by the natural logarithm of annual average total assets over the past three years.

Wank (1996) argues that firm size is irrelevant to government *Guanxi* because Chinese pursue business in networks rather than as part of corporate strategies, in which profits are not reinvested in existing firms, but into new firms linked to the parent firm through overlapping kinship ties of management and ownership. This creates business groups that embody sizeable investments, even though the size of any one member firm is small. Xin and Pearce (1996) also find that the size of Chinese private firms does not affect the importance of government *Guanxi*. This is because government *Guanxi* plays different roles in private enterprises, where large firms rely more on government trust to enhance their credibility within society and with banks while smaller firms often seek government protection against various kinds of tax and

administrative fees (Sun and Wong, 2001). However, capital stock is critical to the development of Chinese private enterprises. Sun and Wong (2001) point out that due to the small size of most private firms, few people would have enough funds, either from their own savings or from borrowing from family members and friends, to start an enterprise. Thus enterprises have to rely heavily on government and banks in accessing capital for their development. This consideration would suggest that large firms would be more likely to regard government *Guanxi* as more important than small firms.

For family *Guanxi*, Schlevogt (2001) finds that the decision for private firms to remain small is due to the greater emphasis on family *Guanxi*. In other words, the decision to stay small is motivated by the desire to maintain personal relationships with important shareholders (especially other respected and trusted family members) and avoid the inclusion of outsiders, who are viewed with suspicion and distrust. According to Schlevogt (2001), this is a major reason why Chinese private enterprises keep business within the family. Following this argument, small private firms are more likely to regard family *Guanxi* as more important than large firms.

3) *Instability of the business environment (Instability)*. This variable is defined as the standard deviation of changes in sales revenue over the past three years. As shown in Table 2, the instability indicator in the sample was quite large with a mean of 631, indicating that markets in China are volatile. As discussed in Section 2, we expect a positive relationship in the sample between the instability of the business environment

and the perceived importance of both government and family *Guanxi*.

4) Respondents were asked "Do you give gifts to government officials in order to build connections?" Gift-giving (*Gift*) is a binary variable set equal to 1 if firms responded that they give gifts to government officials in order to build connections; set equal to zero otherwise. There were 63 firms who reported that they gave gifts to government officials to build connections, accounting for 1.8% of the total 396 firms. In the context of the gift economy in China and given the general expectation that gift-giving will cultivate connections, a positive relationship between gift-giving and the perceived importance of government *Guanxi* is expected. In the model examining the importance of government *Guanxi*, we will consider whether gift-giving is endogenous. If gift-giving is found to be endogenous a structural equation will be estimated after substituting estimates of the endogenous variable.<sup>6</sup>

### 3.4 Econometric methodology

To examine the determinants of the perceived importance of government and family *Guanxi* in the two ordered logit models, we take into account multicollinearity, heteroskedasticity, and possible endogeneity of the gift-giving variable.

INSERT TABLE 3

As shown in Table 3, there is no simple correlation in the sample between any two variables in excess of 0.6, which means that multicollinearity is not a concern and does not require any remedy (Gujarati, 1995). However, heteroskedasticity may be a

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<sup>6</sup> Lee (1979) has shown that the resulting parameter estimates from this procedure in models with limited (censored) dependent are consistent if the structural equation is identified exactly.

problem in models employing cross-sectional data, with firms with large differences in size and in variance of sales, as shown in Table 3, in order to avoid the potential problem of heteroskedasticity in the sample, we employed a robust technique with White's heteroskedastic consistent z-statistics in both ordered logit models.

In addition, we employed Hausman's specification error test to examine whether the gift-giving variable is endogenous in the government *Guanxi* model. The test is reported in Table 4, where model (b) refers to the government *Guanxi* model without the gift-giving variable and model (B) refers to the government *Guanxi* model with the gift-giving variable. Our diagnostic testing shows that the difference in coefficients between models (b) and (B) fits the asymmetric assumptions, indicating that the coefficients in the government *Guanxi* model with the gift-giving variable are consistent and efficient. Therefore, gift-giving is not an endogenous variable in the government *Guanxi* model.

,NSERT TABLE 4

## **4 Empirical Results for the Determinants of the Perceived Importance of Government and Family Guanxi**

### **4.1 Econometric results**

The empirical results for the perceived importance of government and family *Guanxi* in private enterprises are reported in Table 5.

,NSERT TABLE 5

Firm age (Age) has an insignificant effect on the perceived importance of government *Guanxi*, while it has a strongly positive effect on the perceived importance of family

*Guanxi*, contradicting our expectations. For government *Guanxi*, the finding suggests that the importance of government *Guanxi* does not decrease in newly-established private enterprises. This result can be explained by the enduring strength of government *Guanxi* due to its deep embeddedness in Chinese culture, which is consistent with the argument that traditional culture is difficult to change (North, 1990; Weitzman and Xu, 1994). In this manner, it can be argued that the significance of government *Guanxi* has not diminished in contemporary China, as some researchers have suggested (Yang, 1994, 2000; Xin and Pearce, 1996; Standifird and Marshall, 2000). For family *Guanxi*, the finding shows that old firms are more likely to regard family *Guanxi* as being more important than young firms, implying that family *Guanxi* is given more importance by private firms as firm age increases. This result will be further analysed in Section 5 below where firm preferences for family versus government *Guanxi* are examined.

The positive relationship between firm size ( $\ln \text{Asset}$ ) and the perceived importance of government *Guanxi* suggests that large firms care more about government *Guanxi* than small firms, confirming our expectation. That is, although many small firms may seek more government protection against tax and administrative fees, firms perceive government *Guanxi* as important in obtaining financial resources. This result is consistent with the argument that their larger scale and scope place these firms in a better position to initiate larger projects, and that these larger-scale projects are often much more attractive to the government and to banks (Guthrie, 1998). This is also

because the larger the firms, the better the development of their *Guanxi* network (Standifird and Marshall, 2000), and hence it is easier for them to get support from the government. To obtain closer connections with the government, Sun and Wong (2002) suggest that private firms need to take the initiative in getting involved in government-sponsored projects such as the 'Hope Project' and the 'Glorious Program'.<sup>7</sup> This may generate, as Wank (1996) put it, 'mutual understanding' or 'mutual concern' between the government and private firms. The difficulty that small firms face in getting assistance from the government was emphasized in some interviews in the survey. For example, an owner of one private firm stated:

'Every enterprise has to establish all kinds of links with the government. In so doing, besides considering our business interests we are also seeking some kind of protection from the government, particularly before the recognition of private firms by the government in the early reform period. However, we have many difficulties in communicating with the government, as in the old saying *wu present the pig-head but the temple does not accept it* (Tizhezhutoumeimiaojin).<sup>8</sup> That is, the government does not really care about us.' (Personal interview in Ningbo, 2005)

On the other hand, firm size (LnAsset) has an insignificant effect on the perceived importance of family *Guanxi*, indicating that small firms do not view family *Guanxi* as more important than large firms. This result suggests that due to the prevalence of family-based values, private firms may grow larger while keeping the strength of family relationships (Yeung, 2000). This finding is consistent with agency theory that agency costs do not increase when Chinese private enterprises grow larger because family relationships can be used to improve monitoring and to provide incentives to

<sup>7</sup> The objective of the 'Hope Project' is to improve basic education in remote villages while the objective of the 'Glorious Program' is to develop western China. They are both organized by the Chinese government.

<sup>8</sup> In this expression, the 'pig-head' refers to gifts and favours while the 'temple' refers to authorities such as the government.



reduce agency costs.

The instability of the business environment (,nstability) has a strongly positive effect on the perceived importance of both government and family *Guanxi*, confirming our expectations and supporting *hypothesis 1* of this paper. The result indicates that it is better for private firms to use government and family *Guanxi* in a developing market such as China.

The positive effect of gift-giving (Gift) on the perceived importance of government *Guanxi* means that those firms who give gifts to government officials to build connections are statistically more likely to regard government *Guanxi* as being more important. This also confirms our expectation.

#### **4.2 The usefulness of government and family *Guanxi***

Government *Guanxi* was viewed as quite useful by private firms during the interviews.

For example, an owner-manager of one private firm stated:

<sup>3</sup> Government *Guanxi* matters for getting things done in our business. ,n the past we relied on government *Guanxi* to obtain some kinds of advantage such as material needs. Nowadays, a good relationship with the government can enhance business in the market because the government still dominates almost every aspect of our business. At present the importance of government *Guanxi* may decline in some social domains, but flourish in new areas « ' (Personal interview in Ningbo, 2005)

This statement illustrates that government *Guanxi* is considered important in private enterprises. With respect to the roles played by government *Guanxi* for private enterprises, another manager of a green-field private firm stated:

<sup>3</sup> Government *Guanxi* is very important everywhere in China because the

government controls state contracts, banks loans, access to imports, favourable tax incentives, access to valuable market information, exemptions from troublesome laws and regulations, and so on « We hope, however, that we can do our business relying on market rules instead of the government.' (Personal interview in Ningbo, 2005)

This view is supported in the survey in response to the question: 'what is the main role that the government has been playing and the role that you expect the government will play in the future within your firm' The results are reported in Table 6.

INSERT TABLE 6

As shown, 59 firms, accounting for 19.9% of the sample, reported that the most important role for government *Guanxi* was to facilitate 'access to financial resources.' This result supports the argument by Sun and Wong (2007) that the government is important in providing the foundations for institutional trust for private firms, particularly in accessing bank loans. Overall 57 firms, accounting for 19.3% of the sample, viewed government *Guanxi* as most important for 'protection.' This result confirms the argument that the government supports the institutional innovations of the Zhejiang model, where the first innovation of the Zhejiang model was the practice of 'wearing a red hat' during the period from the late 1970s to the mid-1980s. The second innovation was the formation of joint-stock cooperatives from the mid-1980s to the mid-1990s, and the third was the practice of limited liability companies or joint-stock companies that occurred from the late 1990s. Particularly in the early reform period, local governments allowed private entrepreneurs to register their firms as 'collectives,' thus releasing them from the restrictions placed on private

firms (Wank, 1996; Sun, 2000, 2001). As discussed above, there were 63 private firms in the sample transferred from 'collectives,' accounting for 97.7% of the total 68 transferred firms. Most of these collectives had been 'red-hat' firms that had taken off their 'red hats' since the ownership reform policy in 1997, meaning that there were no 'red-hat' firms in the survey. Altogether 91 firms, accounting for 30.7% of the sample, reported that the most important role for government *Guanxi* was to provide 'technological support and services.' In fact, it has been argued that along with the market-oriented reforms in China, government *Guanxi* has moved away from the acquisition of consumer goods and the provision of everyday needs. However, it has flourished in the realm of business and the urban-industrial sphere, whether in dealings among private entrepreneurs or between private entrepreneurs and local officials (Yang, 2001). Since the role played by the government in private enterprises may have changed, this result also reflects the expectations of Chinese private enterprises with respect to the role played by the government.

Family *Guanxi* was also viewed as very useful in private firms during the interviews.

For example, an owner of one green-field private firm stated:

'Family relationships are the core of the moral system defined by traditional Confucius thought. For my business, my family has been a reliable source of cheap and flexible capital and labour, particularly in the business start-up phase. However, this is not the end of family *Guanxi*. In fact, family *Guanxi* enables me to embrace others who may assist my business.' « My firm faced a threat of serious punishment several years ago for a tax infringement, but one of my father's friends [working in the government] intervened and we only received a minimal level of punishment. » (Personal interview in Ningbo, 2005)

Indeed, it has been shown in many studies that family *Guanxi* is important for the

development of Chinese private firms (Schlevogt, 1991; Gan, 1991), particularly in providing cheap and flexible resources, and in extending network resources (Sun and Wong, 1991). This view is supported in the survey in responses to the question: 'what is the main role that family members have been playing or will play in your firm'.

The results are reported in Table 7.

INSERT TABLE 7

Overall 150 firms reported that the most important role of family *Guanxi* was to 'provide cheap and flexible resources such as capital and labour,' accounting for 51.4% of the sample. This was a major reason why family businesses account for the majority of private firms, and also the fact that most firms are small because private resources are relatively limited compared with those of the government and banks (Sun and Wong, 1991). However, this view implies that it is easy for private entrepreneurs to get help from their family members. In addition, 74 firms, accounting for 49% of the sample, considered that the most important role of family *Guanxi* was to 'extend the firm's network of connections outside the firm.' This supports the argument that although family-centred, family *Guanxi* is an important avenue to extend networks of the firm (Sun and Wong, 1991). Altogether 60 firms, accounting for 40% of the sample, considered that the most important role of family *Guanxi* was to 'assist in decision making within the firm,' so that family relationships can be used to reduce agency costs, as discussed in Section 3.

#### Private Firms' Preference for Government or Family *Guanxi*

The empirical results in the previous section showed that there is a significant and positive effect of business instability on the perceived importance of both government and family *Guanxi*. However, the differences are notable between government and family *Guanxi* in private firms with respect to firm age and firm size. To examine the decision whether to choose government or family *Guanxi* for cooperation in terms of firm characteristics in Chinese private enterprises, a probit model was employed to test which factors explain the firm's *Guanxi* preference.

### □1 Description of the model

Respondents were asked the question: "would you prefer to cooperate with government or family members in your firm?" The dependent variable is a binary variable set equal to 1 if the firm prefers government for cooperation and set equal to zero if the firm prefers to cooperate with family members. In the sample 135 firms chose the government and 161 firms chose family members for cooperation, accounting for 45.6% and 54.4% respectively of the total 296 firms. The independent variables are firm age (Age), firm size (LnAsset), the instability of the business environment (Instability), and gift-giving (Gift), which were defined in Section 3.

### □2 Regression results

In contrast to the previous ordered logit models where government and family *Guanxi* were examined separately, in this model firms have to make a trade-off between government and family *Guanxi* for cooperation. In other words, although government and family *Guanxi* are regarded as important in private firms, a private firm may

prefer one over another if the firm has a choice. This is because government and family *Guanxi* differ in terms of trustworthiness, as well as their effect on corporate governance, as discussed in Section 11. Given these two options, the empirical results of the probit model of the firm's preference for government or family *Guanxi* are directly opposite. The results are reported in Table 8, where the positive coefficients indicate a preference for government and the negative coefficients refer to a preference for family members.

INSERT TABLE 8

The negative coefficient on firm age (Age), which is significant at the 5% level, indicates that young firms prefer government for cooperation while old firms prefer family members for cooperation. For newly-established private firms, however, although the significance of government *Guanxi* might not diminish in a transitional economy, as discussed above, cooperation with the government is not facilitated by improvement in the economic environment.<sup>9</sup> More importantly, the finding suggests that private firms will prefer family *Guanxi* over government *Guanxi* for cooperation as the firm's age increases. This is true even for those firms who experienced the early reform period containing the 'red-hat' phenomenon in which the government had played an important role. In this sense, the importance of government *Guanxi* is declining relative to family *Guanxi* in private firms.

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<sup>9</sup> For example, due to the development of a rational-legal system and the evolution of increasingly competitive markets in China (Li, 1998; Gregory et al., 2000; Singh, 2003), cooperation with the government is restricted by policies such as ownership reform, which require the government to withdraw from direct involvement in the firm's economic activities (Sun, 2000, 2002).

Firm size, which has a significant positive effect on the importance of government *Guanxi*, does not statistically affect the firm's preference for government or family members. While large firms care more about government *Guanxi* than small firms because government *Guanxi* is very useful in accessing financial resources, small and large private firms have the same preference for cooperation with either the government or family. This reflects the importance of family *Guanxi* in private firms, even for those firms which have grown larger in size (Yeung, 2000).

The instability of the business environment (Instability) has a negative sign in the probit model, which is significant at the 5% level. The result indicates that government is chosen in a relatively stable business environment compared with family members who are chosen in a relatively unstable business environment. Because government and family *Guanxi* represent separation or non-separation of ownership and control in private firms, as discussed in Section 3; this finding is consistent with the argument that because of family *Guanxi*-based inter-organization networks, decision making in family firms is more efficient and flexible than in firms managed by professional managers in responding to environmental changes (Yeung, 2000). This result does not deny the important role played by the government in a volatile business environment, but rather suggests that in a more volatile business environment firms need to have a more rapid response to changing market conditions in order to ensure better firm performance, and this may be realized more effectively if ownership and control are not separated. In other words, due to the relative difficulty of monitoring an agent's performance in a more volatile business

environment, the owner of the firm will prefer to exercise control him or herself to ensure that his or her interest is protected.

Gift-giving (Gift) does not have a statistically significant effect on the firm's *Guanxi* preference, meaning that firms who give gifts to government officials to build connections do not statistically prefer cooperation with the government. That is, gift-giving is not a determinant of preference for government *Guanxi* although it positively affects the importance of government *Guanxi* in China's gift economy. This finding is consistent with the argument that the gift is usually offered without an explicit demand for a return (Xin and Pearce, 1996; Wank, 1996), especially if the cooperation with government is viewed as the result of the exchange.

### **□3 Firm preference for family *Guanxi* or government *Guanxi***

The above analysis in the probit model showed that young firms are more likely to choose the government for cooperation in a relatively stable business environment while old firms prefer family members for cooperation in a relatively volatile business environment. These two significant factors, firm age and the instability of the business environment, which affect the firm's *Guanxi* preference, are consistent with the findings for the determinations of the perceived importance of family *Guanxi* in the previous ordered logit model. That is, as firm age increases in a relatively volatile business environment, a private firm is more likely to regard family *Guanxi* as more important and hence prefer family members to government for facilitating cooperation. To put this argument differently, the findings in the firm's *Guanxi* preference model



indicate that in the currently immature market environment in China, although a newly-established private firm prefers government for cooperation, the firm will choose family members for cooperation as firm age increases. In this sense, government *Guanxi* is replaced by family *Guanxi* in facilitating cooperation in private firms, confirming *hypothesis 2* of this paper.

In addition, relating to the different effects of government and family *Guanxi* on a firm's economic activities, reliability or loyalty have been emphasized in many studies of corporate governance in private firms (James, 1999; Lovett et al., 1999; Yeung, 2000; Schlevogt, 2001; Gan, 2002; Sun and Wong, 2003). The following statement by one owner-manager is representative of many Chinese private enterprises:

‘To be honest, the practice in my firm is to promote those who are loyal, and to use those who are capable. In other words, the loyal will supervise the capable, and not the other way around.’ (Personal interview in Ningbo, 2005)

Although this statement does not clearly refer to the government or to family members, the distinction between government and family *Guanxi* is reflected in its essence. As discussed in Section 4, family *Guanxi* generally embodies a higher level of ‘loyalty’ while the use of government *Guanxi* is represented as a higher level of ‘ability.’ When facing these options, a private firm would choose family members ahead of those outside the family circle.

## 6 Conclusion

This paper has employed the concept of trust (*Guanxi*), which comprises both

government and family trust, to investigate the changing patterns of corporate governance in Chinese private enterprises, with a focus on the Zhejiang model. Two hypotheses raised in this paper have been tested by empirical studies based on the survey of 196 firms in Ningbo, Zhejiang province. The study of the determinants of government and family *Guanxi* suggests that both government and family *Guanxi* are perceived as important for the development of Chinese private enterprises, particularly in the relatively volatile markets in China compared with many developed countries. However, the empirical results further show that private firms prefer family members over the government for cooperation as the firm ages and the instability of the business environment increases, confirming that family *Guanxi* is replacing government *Guanxi* within Chinese private enterprises. The findings in this paper give support to our understanding of why family businesses constitute the majority of Chinese private firms, as well as reflecting the different effects of government and family *Guanxi* on the firm's economic activities, representing respectively the separation or combination of ownership and control in terms of corporate governance in private firms.

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Table 1 Industrial Distributions of Ningbo's Private Enterprises and Survey Firms at the End of 2004

	Ningbo City		Survey Firms	
	firms	proportion	firms	proportion
Total firms	68,500		196	
Primary industry	840	1.20%	8	4.10%
Secondary industry	39,860	58.10%	163	55.07%
Of the total: Manufacturing	37,395	54.59%	150	51.35%
Construction	2,090	3.05%	10	3.38%
Tertiary industry	27,800	40.60%	125	41.13%
Of the total: Wholesale and retail trade and catering service	17,590	25.68%	66	21.30%

(Source: Report of Development of Ningbo's Private Enterprises (2005) and Researchers' Survey)

Table 2 Descriptive Statistics of the 196 Private Enterprises

Variable name	Description of variable	Means/Frequencies
Government <i>Guanxi</i> (Gg)	The importance of Gg on a 5-point scale 1=not helpful at all 2=relatively not helpful 3=neutral 4=relatively helpful 5=very helpful	Mean=3.79 (S.D.=1.02) Freq.=6 (3.03%) Freq.=31 (10.47%) Freq.=60 (30.57%) Freq.=110 (40.54%) Freq.=79 (36.69%)
Family <i>Guanxi</i> (Gf)	The importance of Gf on a 5-point scale 1=not helpful at all 2=relatively not helpful 3=neutral 4=relatively helpful 5=very helpful	Mean=3.80 (S.D.=0.96) Freq.=8 (4.10%) Freq.=19 (6.41%) Freq.=65 (31.96%) Freq.=136 (45.95%) Freq.=68 (31.97%)
Age (Years)	Years registered as a private firm	Mean=6.45 (S.D.=3.33)
LnAsset	Natural log of average gross assets over the past three years (million RMB)	Mean=0.80 (S.D.=1.57)
Instability (%)	Standard deviation of sales over the past three years	Mean=630.69 (S.D.=956.84)
Gift-giving (Gift)	A binary dummy variable where 1=giving gifts to government officials to build connections, 0 otherwise	11.28% (63 firms) of the total were giving gifts to government officials to build connections

Table 3 Correlation Matrix

	Gg	Gf	Age	LnAsset	,nstability	Gift
Gg	1.0000					
Gf	0.0414	1.0000				
Age	-0.0781	0.1785	1.0000			
LnAsset	0.1380	0.1796	-0.0789	1.0000		
,nstability	0.1913	0.1914	-0.0569	0.5008	1.0000	
Gift	0.1545	-0.0384	0.0033	0.1054	0.0900	1.0000

Table 4 Hausman's Specification Test for Gift-Giving

	Coefficients			
	(b) Partial	(B) all	(b-B) difference	sqrt(diag(V_b-V_B)) s.e.
Age	-0.006801	-0.0071415	0.0003406	0.0019716
LnAsset	0.0016485	0.1949353	0.0067131	0.0187806
,nstability	0.0001773	0.0001730	4.09e-06	0.0000147
Test	Ho: difference in coefficients not systematic $\chi^2(3) = (b-B)'[V_b - V_B]^{-1}(b-B)$ $= 0.11$ $\text{Prob} > \chi^2 = 0.9754$			
Result	do not reject Ho			

Notes: b = consistent under Ho and Ha; obtained from ologit.

B = inconsistent under Ha, efficient under Ho; obtained from ologit.

Table 5 The Determinants of the Importance of Government *Guanxi* (Gg) and Family *Guanxi* (Gf)

Ordered logistic regression with robust standard errors	Gg	Gf
Age	-0.0071415 (-0.10)	0.0910613 <sup>a</sup> (1.77)
LnAsset	0.1949353 <sup>b</sup> (1.18)	0.1304104 (1.51)
Instability	0.0001731 <sup>a</sup> (3.58)	0.0001731 <sup>b</sup> (1.49)
Gift	0.5954113 <sup>b</sup> (1.50)	
Number of firms	96	96
Log pseudolikelihood	-386.50838	-371.49164
Pseudo R <sup>2</sup>	0.0380	0.0360
Wald chi <sup>2</sup> (4)	43.05	19.84
Prob>chi <sup>2</sup>	0.0000	0.0000

Notes: a, b, c stand for significant at 1%, 5%, 10% level respectively. z-statistics are in parentheses.

Table 6 The Usefulness of Government *Guanxi* in Private Firms

	Freq.	Percent	Cum.
Protection	57	19.16	19.16
Market access	38	11.84	31.09
Tax preference	51	17.23	49.32
Access to financial resources	59	19.93	69.26
Technological support and services	91	30.74	100.00
Total	96	100.00	

Table 7 The Usefulness of Family *Guanxi* in Private Firms

	Freq.	Percent	Cum.
Provide cheap/flexible resources	15	51.35	51.35
Manage financial affairs	7	13.36	53.71
Assist in decision making	6	10.95	74.66
Extend network resources	74	55.00	99.66
Build up family reputation	1	0.34	100.00
Total	96	100.00	

Table 8 Probit Regression of Firm Preference for Government or Family *Guanxi* on Control Variables (Age, LnAsset, ,nstability, Gift)

Probit regression with robust standard errors	Firm's <i>Guanxi</i> Preference
Age	-0.0541167 <sup>b</sup> (-1.40)
LnAsset	-0.0468863 (-0.77)
,nstability	-0.0006551 <sup>b</sup> (-1.39)
Gift	0.1897119 (1.53)
Constant	0.3389908 <sup>b</sup> (1.96)
Number of firms	96
Log pseudolikelihood	-190.78767
Pseudo R <sup>2</sup>	0.0649
Wald chi <sup>2</sup> (4)	16.10
Prob>chi <sup>2</sup>	0.0018

Notes: a, b, c stand for significant at 1%, 5%, 10% level respectively. z-statistics are in parentheses.