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Particularistic and system trust among small and medium enterprises: A comparative study in China's transition economy

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ABSTRACT

Guanxi, a type of particularistic trust observed in Confucian societies has mostly been viewed as a static phenomenon. It is not clear how the role of *guanxi* changes over time during institutional transitions. This field study of twenty one small and medium enterprises (SMEs) located in two large cities in Western China examines the changes in SME behaviors since the beginning of economic reforms in 1979. Based on neo-institutionalist trust perspectives, the article argues that the role of *guanxi* also arose from the paucity of market system trust created by the absence of well-established market institutions during China's transition from a centrally planned to a market economy. *Guanxi* became relatively less important when market system trust based on well-established institutions was firmly established. Regardless of past practices, the dynamics of institutional transitions leading to the establishment of system trust inevitably reshapes managerial as well as business behaviors, with adaptation occurring to the new rules of the market economy.

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1. Executive summary

Arising from the unique attributes of Chinese culture, *guanxi*, based on personal contacts, connections and trust has long been considered an important ingredient in successfully conducting business in China. The business literature is replete with examples of potential collaborations that have been aborted, negotiations that have been deadlocked, or of deals that have gone awry, owing to the lack of trust between the business partners involved. Indeed, conventional wisdom and the business literature in particular, enjoins executives to devote their attention and time to developing relationships with their prospective Chinese business partners, prior to actually engaging in the proposed business activity or transaction. This is regarded as a means of developing trust, which is essential in the Chinese (and some other Asian) business contexts.

To some extent these practices of engaging in trust building are contrary to the Western ideals of efficiency and productivity, which would predicate that the negotiations be concluded in the shortest time, and in the most expedient manner possible. Moreover, in traditional Western settings, clear demarcations are established between personal relationships and business relationships. Whereas the former are typically based on affective, emotional, belief or kin-based commonalities, business relationships are based on consensually agreed on business practices, the laws relating to contracts, the institutional frameworks that govern these contracts and their consequent enforceability. In both situations, the common goal is to reduce the risks involved in the exchanges with another party that one had no control over, and to protect oneself against the possibility of exploitation or of being cheated.

However, the mechanisms employed to achieve these similar goals of risk reduction are different in personal trust based transactions versus market system based ones. In the instance of personal trust, the reliance is on communications, obligations, expectations and emotional bonds between individuals that would cause pain to both parties in the event of betrayal. Further, the

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betrayal of this personal trust could have broader consequences for the betrayer in terms of being denied future credibility and lubricating social capital in the network. In the case of market transactions, the risk is reduced through the reliance on the institutions, the legal framework governing the transactions and the possibility of sanctions (in other words, a form of trust in the system, as opposed to trust in individuals).

Besides cultural factors, another major reason for the reliance on personal trust in the Chinese context was either the complete absence or the inadequacy of institutions that support a market economy. The economy and business environment in China has been undergoing a gradual and sustained process of transition since the beginning of reforms in 1979. Over a period of three decades the centrally controlled economy and its institutions have been dismantled and phased out, to be gradually replaced by the market economy and its accompanying institutions and practices.

Based on in-depth interviews, information from other materials and sources, and the inductive analysis of the data obtained from twenty one privately owned enterprises in China that were in existence during the period from 1979 to 2005, this article argues that the role of personal trust in business dealings in China during this transition period was not only based on the unique cultural context, as is commonly argued, but was also greatly enhanced because of the relative paucity and weakness of relevant institutions, during the transition period from one type of economic system to the other. This period of transition was also characterized by the emergence of a new type of enterprise in the Chinese economy, the privately owned company. The roles, rights and responsibilities of these privately owned enterprises were not clearly spelt out during this transition period, leading to their existing in a grey legal, economic and regulatory zone. Therefore, the entrepreneurs and managers of these newly created privately owned enterprises, had to rely on their contacts, connections and personal networks to successfully initiate and conclude business transactions, including mundane functions like winning orders, accessing and obtaining complementary resources, procuring supplies, obtaining payments and eliciting co-operation from State Owned enterprises and other quasi-governmental agencies.

The lessons are self-evident for managers of all enterprises in similar situations of economic transition, both in China as well in other countries. First, do not rely exclusively on any one form of trust, either personal trust or system trust. Instead, employ a judicious combination of both types of trust in order to get things done. Second, employ a combination of both these types of trust mechanisms in transactions involving both friends and acquaintances, as well as complete strangers. It is better to be even handed in dealings with all and different sets of people. Third, shift the relative emphasis from personal trust to system trust as early as the ongoing economic transition and institutional evolution permits the shift. When dealing with family and friends, move them to systems based trust and contract-based transactions, as early as is feasible. This will also help in protecting and preserving these relationships, in the long-term. Finally, in these situations, there is no cookie cutter solution for all problems. The relative mix between personal and system trust in any transaction has to be dealt with on an issue-by-issue basis, depending on the specific nature of the problem, the repertoire of skills possessed by the entrepreneur, the background and nature of the partners, the age, history and culture of the enterprise, the characteristics of the industry, the geographic location, and the stage of the transition process.

Guanxi is an informal, particularistic personal relationship between two individuals who are bounded by an implicit psychological contract to follow the social norms of maintaining long-term relationships, mutual commitment, loyalty, obligation and trust (Chen and Chen, 2004; Tsang, 1998; Yang, 1994; Xin and Pearce, 1996). It is uniquely rooted in the context of Confucianism and to some extent Taoism and Buddhism (Carlisle and Flynn, 2005; Farh et al., 1998; Tsui and Farh, 1997). Guanxi building is the process of producing trust between parties, and the accessibility or quality of guanxi is determined by the level of personal trust existing between parties (Chen and Chen, 2004).

Two forms of trust are personal trust or particularistic trust between specific individuals, and system trust or general trust in non-specific others (Barber, 1983; Luhmann, 1979; Luo, 2005; Zucker, 1986). Particularistic trust may be based on a person's competence, personality traits, expressed sense of morality (Bulter and Cantrell, 1984), from observations of benevolent behaviors (Bulter, 1991; Mishra, 1996), or from effective social interactions (Zucker, 1986). By contrast, system trust originates from institutional norms and safeguards. With system trust, a person might trust a complete stranger because the latter is acting in accordance with the dominant norms and standards. However, trust does not function in an institutional vacuum (Luo and Chung, 2005; Peng, 2003) and is thus dependent on the 'trusters' and the 'trustees' being embedded in, and acting within the context of institutional norms (e.g., Bachmann et al., 2001; Lane and Bachmann, 1996; Zucker, 1986).

Economic transitions provide a unique opportunity to examine a wide range of issues, such as the changing institutional environment and firm strategic responses (including the role of trust in business practices), as well as how they co-evolve over time (Tan and Tan, 2005). Guanxi or particularistic trust may have substituted for formal institutional mechanisms during the early stages of China's economic transition because of the underdeveloped state of market institutions (Child and Möllering, 2003; Xin and Pearce, 1996). Although economic reforms in China began in 1979, system trust based on a market economy emerged only much later. The effect of such institutional transitions on the changing role of guanxi in business practices over time has remained largely unexplored (Alston, 1989; Jacobs, 1980).

Thus, our major research questions were:

- How does the form and applicability of the different types of trust (i.e., Particularistic trust or System trust) in business transactions, vary with the transitions occurring in the institutional environments?
- How does the transformation of trust shape business behaviors and contribute to business success?

Our study was based on 50 lengthy semi-structured interviews conducted with entrepreneurs or top managers of twenty one Small and Medium Enterprises (i.e., SMEs) located in two cities in Western China, in late 2004 and early 2005. Based on the

inductive analysis of the data obtained from these field interviews and other supporting documents that were provided, we examined the nature of trust transformation and their effects on SME behaviors and performance, in the context of China's ongoing economic and institutional transitions.

2. Theoretical frameworks

2.1. Institutional theory

Institutional frameworks establish the 'rules of the game' through defining the political, social and legal rules governing exchanges and economic transactions between entities ([Meyer and Rowan, 1977](#); [North, 1990](#); [Scott, 2001](#)). Such rules can be both informal as well as formal, based on cultural-cognitive, normative and regulatory elements, and provide both stability and meaning ([DiMaggio and Powell, 1983](#); [Scott, 2001](#), p. 48). In developed market economies, formal rules are incorporated in company and contract laws which govern economic exchanges, and these laws are enforced by appropriate sanctioning authorities. By contrast, informal constraints such as behavioral norms, acceptable codes of conduct, cultural and ideological values provide broader more diffused signposts regarding acceptable behaviors and choices ([Child and Tsai, 2005](#); [Scott, 2001](#)).

Both formal as well as informal components of institutional frameworks guide and regulate individual firm behavior. In most mature market economies, institutional frameworks have reached steady-state equilibrium. By contrast, in economies like China's, which are transitioning from a Centrally Planned to a Market model, both formal and informal institutional mechanisms are changing and evolving over time ([Tan, 2007, 2005](#)). With the State relinquishing its role in governing economic transactions, with the increasing presence of private firms, collectively owned firms, and multinational joint ventures (in addition to the traditional State owned Enterprises or SOEs), economic exchanges have gradually become more market-based rather than based on central planning dictates ([Tan, 2007](#)). However, the formal, regulatory, coercive institutional mechanisms that under gird a market economy like property rights, company and contract laws, legal frameworks for managing and settling disputes, and concomitant sanctions are still evolving, or in some instances non-existent. With the devolution of authority and power from central government planning bodies to local authorities, the institutional authority structure is in flux and subject to interpretation. Based on evolving industrial policy, there are variations in the consistency with which market principles are applied across economic sectors as well as by region. Thus, in a vast country like China, the provinces on the East Coast were ahead of other provinces in the interior in establishing market-oriented reforms and institutional structures. The combination of these circumstances resulted in market imperfections ([Cohen and Winn, 2007](#)), a governmental authority structure that was not market-augmenting ([Saravathy, 2004](#)), with consequent effects on entrepreneurial opportunities and performance.

This study also enables the replication, refinement and extension of theories on trust that were developed mostly in Western societies ([Child and Möllering, 2003](#); [Doney et al., 1998](#); [Schoorman et al., 2007](#); [Williams, 2007](#)). Additionally, it also suggests how authorities as well as entrepreneurs in other transition economies can manage during the transformation of their institutional environments.

2.2. Forms of trust and trust production

A requirement for trust production is the existence of high risk situations predicated on two crucial requirements ([Lewis and Weigert, 1985](#); [Luhmann, 1988](#); [Schlenker et al., 1973](#)). First, there are uncertainties or risks involved in social relationships, making one person vulnerable to exploitation by others. Second, the expectation of the actor's goodwill allows the target to ignore these risks. Social structure and institutional arrangements influence people to act in predictable ways ([Luhmann, 1979](#); [Zucker, 1986](#)) while social ties and types of network structure play important roles in the process of producing trust in others ([Granovetter, 1985](#); [Uzzi, 1996](#)).

However, trust is not only a set of positive beliefs or expectations about trustees ([Rotter, 1971](#)) but also a willingness to act on those beliefs ([Luhmann, 1979](#)). The reliability and dependability manifested in previous social interactions with an actor gives rise to positive expectations about the target's trustworthiness. Frequent, long-term interactions lead to emotional attachments based on reciprocated interpersonal care and concern ([McAllister, 1995](#)). Certain characteristics such as common family background, religion or ethnicity ([Zucker, 1986](#)) will also produce trust between parties. This form of trust is referred to as personal or particularistic trust ([Luhmann, 1979](#)).

The second type of trust is a cognitive or rational process discriminating among individuals or institutions that are untrustworthy, distrusted, or unknown ([Lewis and Weigert, 1985](#)). Here, we cognitively choose whom we will trust, in what respects and under which circumstances, based not on knowledge about the target's intentions or expected behaviors, but instead based on stable social institutions and legal systems ([Luhmann, 1979](#); p. 34). These institutions reduce the risk in conferring trust. This form of trust is referred to as system trust ([Barber, 1983](#); [Luhmann, 1979](#)).

The emotional pain that either individual experiences in the event of betrayal serves as the protective basis for personal trust, even where other types of short-term gains could be realized by breaking the trust. This emotional content is largely absent in system trust, which rests on a 'presentational' base that everyone can observe. Personal trust exists mainly in close interpersonal relationships, where mutual obligations and goodwill have been certificated over a long-term social interaction (such as with friends) or is simply taken for granted because of the actors' identity (such as in kinship). But this close interpersonal relationship is largely absent in system trust, which can even exist between acquaintances or complete strangers with weak interpersonal relationships, but who have clear and mutually consistent assumptions regarding the defined rules for interaction ([Coleman, 1993](#);

Zucker, 1986). The legal system serves as a background structure in the case of system trust, providing for the possibility of sanctions, and thus preventing actors from cheating (Luhmann, 1979). Therefore, a well-established institutional environment is a pre-requisite for system trust to develop. In personal trust, two aspects of social relationships, one the communication that enables coordination among norm beneficiaries, and second, the obligations and expectations that subsume the cost of sanctioning, are important mechanisms for generating effective sanctions (Coleman, 1990; pp. 270–273). Small and relatively undifferentiated societies rely more on particularistic trust while modern, complex societies are characterized by system trust with a greater emphasis placed on the functioning of bureaucratic sanctions, safeguards, and the legal system (Luhmann, 1979; Zucker, 1986).

Based on Confucian values, Chinese culture emphasizes kin, community, or family relationships and quasi-relative relationships (Weber, 1920/1995). Instead of a government by law, the Chinese people always preferred a government by 'gentlemen', which is more personal, more flexible and more human (Lin, 2000). These historical traditions rendered it indiscreet to rely completely on institutions at the expense of personal relationships. However, beginning with China's transition and the economic reforms introduced in 1979, and spurred by the rapid internationalization necessitated by its entry into the World Trade Organization in 2001, Chinese firms experienced a transformation in the forms of trust utilized. The role of central planning and government institutions as mechanisms in business transactions declined (Tan, 2007, 2005). Because of these eroding institutional mechanisms, hierarchical modes of operation were replaced by particularistic trust based on personal connections and guanxi, during the early stages of the transition process. With the eventual establishment of market institutions, particularistic trust was gradually replaced by systems trust and a greater reliance on the newly established market-based institutions.

2.3. Institutional changes and forms of trust

The institutional environment confers legitimacy and stability, which the organization tries to obtain mainly through acquiescence or compromise strategies (Oliver, 1991). From a resource dependence perspective, the task environment is sometimes more important for the acquisition and control of factors of economic production (Oliver, 1997). Moreover, depending on whether the organization's environments could be characterized by high regulatory stringency or by high resource stringency, or by both (Oliver, 1997), differing levels of attention and different sets of responses might be required. Institutional transitions are also likely to introduce considerable chaos and increase costs, as new institutions emerge to replace old ones (Oliver, 1992). Trust, guanxi and business networking were important mechanisms that enabled Chinese SMEs to deal with the uncertainty and increased risks arising from ongoing institutional transitions.

It is necessary to combine the examination of forms of trust with the processes of institutional transitions in order to understand SME behaviors and explain how institutional transitions affected these behaviors during the transition stages. Transition stages are often characterized by the use of informal institutional networks such as fiefs or informal personal mechanisms such as clans or guanxi (Boisot and Child, 1988).

2.4. Economic transitions and institutional changes in China

China followed a principle of 'pragmatism', balancing the pace of reform with social stability (Lin, 1998; Tan, 2005). Due to sensitive political and social considerations, institutional reforms have been non-linear, often displaying a mix of progress and regression (Nee, 1992; Nolan, 1995). A broad range of policies and regulations were gradually introduced to accompany the transition process, as detailed in Table 1.

The first stage of economic transition in China was from 1979 to the late 1990s, during which multiple systems of business ownership (i.e., existing SOEs, along with a nascent private sector) and governance emerged (Boisot and Child, 1996). These multiple forms eventually achieved approbated legal status resulting from conscious experimentation by Chinese authorities. There were three landmark events during this transition process (see Table 1 for details): (1) Constitutional amendments in 1982 stipulated that the rights of self-employed individuals be protected (Dong, 1999; p. 416). This spurred the development of private enterprises and Township & Village Enterprises (TVEs). (2) In 1988, the Chinese constitution was amended to refer to self-employed

Table 1
Description of key events during transition.

Year	Key Events
1982	Constitutional amendments stipulated that the rights of self-employed individuals, which were deemed as necessary parts of the socialist economy, should be protected.
1988	The Chinese constitution was amended to refer to self-employed individuals and private enterprises as 'useful supplements' to socialist public ownership.
1993	The decision was made to build up a socialist market economy, when the Fourteenth Party Congress proclaimed that some small SOEs may be sold, leased or reconstituted as shareholding companies.
1997	Private enterprises formally shook off their 'supplementary' status, when the Fifteenth Party Congress proclaimed nonpublic ownership as an important component of China's 'socialist market economy'.
1999	The credit guarantee system detailing the nature of, and guidelines for SMEs credit guarantees, was established.
2000	The establishment of a venture capital market in Shenzhen city provided needed financial capital to promising SMEs.
2002	The law promoting SMEs was introduced, in order to further confirm the legal status of private businesses. An indication that SMEs were playing increasingly important roles in China's economy.
2004	The Chinese constitution was further amended to ensure that the state protected the legal rights and interests of individual businesses and private enterprises and encouraged their development.

individuals and private enterprises as ‘useful supplements’ to socialist public ownership (Dong, 1999; p. 417). (3) With the increasing contributions of SMEs to China’s economic growth and labor employment, private enterprises formally shook off their ‘supplementary’ status in 1997. In that year, the Fifteenth Party Congress proclaimed nonpublic ownership as an important component of China’s ‘socialist market economy’.

During the transition, the market track gradually outgrew the central planning track (Naughton, 1995). The Chinese authorities moved an increasing number of economic transactions from governance by hierarchical bureaucratic administration to impersonal contractual exchanges (North, 1990). However, the market system was still quite underdeveloped during these early stages of transition. TVEs and private enterprises survived with difficulty under this dual-track system, as they were excluded from the planning system, and were without legal status. Thus, private firms in early ‘transitional China’ had to find ways to alleviate their ‘liability of privateness’ (Chen, 2007).

The second stage of transition dated from the late 1990s to the present, during which privately owned SMEs grew rapidly and were granted full legal rights (Tan, 2007). Motivated by China’s impending entry into the WTO, the goal of the central government after 1998 became one of expediting the establishment of a legal system to support the effective operation of the market economy (see Table 1). There were accompanying initiatives to support democracy, the rule of law, and market-based economic development. Although the laws in China remained largely ‘tools of state administration’ (Lubman, 1995) and were subject to local interpretation, three positive trends were observed during this period (Child and Tse, 2001): (1) An increasing number of Chinese citizens began using the legal system to resolve disputes, (2) there was a large increase in the number of professional law firms in China, (3) China’s entry into the WTO mandated that laws become essential mechanisms in the business world. Although great progress was made during this time period, institutions in China still remained underdeveloped compared to those in other developed countries (op. cit.). This resulted in the simultaneous use of both forms of trust in China’s transitioning economy. As the planned economy was dismantled and replaced with the market economy, the hierarchical modes of operation disappeared, to be replaced by system trust related to the market economy. But during the interim period, when the institutions necessary for the effective operation of the market system were still evolving, entrepreneurs and managers were compelled to rely on particularistic trust and guanxi to accomplish their transactions. Eventually, with the establishment of market institutions, SMEs were compelled to change and adopt economic transactions based on market-oriented system trust.

3. Research design and methods

The grounded-theory-building approach (Strauss and Corbin, 1998) that we employed is consonant with the call for adopting qualitative, interpretivist methodologies in entrepreneurship research (Coviello and Jones, 2004; Gartner and Birley, 2002), and is particularly appropriate for assessing the evolutionary roles of both particularistic trust and system trust during China’s institutional transformation over time.

3.1. Data collection

Firms in our sample were selected using stratified sampling (Eisenhardt, 1989). The sample comprised matched groups of SMEs that operated in two distinct geographic locations. All the companies in the sample were founded during one of the two different stages of institutional transitions examined, spanning the time period from 1979 to 2004.

We chose Chengdu City in Sichuan province and Xining City in Qinghai province as our sampling areas. Both of these cities are located in Western China. Compared to Eastern China, the economy and market systems in Western China are less developed. However, with the implementation of the central government’s ‘Development of the Western Regions’ strategy begun in 2000, and the added impact of China’s ongoing internationalization (viz., China’s entry into the WTO in 2001), economic reforms and the establishment of a market system in Western China have accelerated. The Sichuan province is economically one of the more advanced provinces in Western China while the Qinghai province is comparatively lesser developed. The GDP (545.632 billion RMB) and population (86,730,000) of Sichuan province ranks first among the twelve Western provinces (Sichuan and Chengdu Statistical Yearbook, 2004). By comparison, Qinghai province had a GDP and population of only 39.021 billion RMB and 5,290,000 respectively (Qinghai and Xining Statistical Yearbook, 2003). The GDP of Chengdu City accounted for about 36.4% of that of the Sichuan province in 2003 (Sichuan and Chengdu Statistical Yearbook, 2004). In 2002, the GDP of Xining City accounted for about 35.6% of that of the Qinghai province (Qinghai and Xining Statistical Yearbook, 2003). The differences in the stages of economic development between the two cities allowed for interesting comparisons.

The criteria for sample selection in both these cities followed the grounded theory building principle that the greater the differences in the sample, the greater the validity of the qualitative analysis results (Strauss and Corbin, 1998). One important criterion in sample selection was to ensure that the selected companies were in different industries. Another criterion was that the selected SMEs should have been founded in the period between 1979 and 2004. With the approval and help of respective local governments, eleven SMEs in Chengdu City and ten SMEs in Xining City were selected, based on the sampling criteria.

The fieldwork in Chengdu City lasted from the 13th October to 29th October 2004, and that in Xining City lasted from 21st March to 4th April 2005. The eight member research team consisted of four sociologists, two management scholars, one anthropologist and an economist, the last two both being from Norway. The research team was divided into two groups of four persons, each group investigating different cases. The two foreign experts were assigned, one into each group to provide advice on qualitative research methodologies and interview techniques. During each interview, one person from the team played the role of interviewer, one person was the scribe, and the other person translated the proceedings for the foreign experts.

Each interview commenced with a brief introduction detailing the purpose, process and implications of our research. Permission was requested to record the interviews. The interviews focused mainly on the interactions between the selected SMEs and other organizations in their external environments. We tried to identify the origins of, process of, and results of each of these interactions, as well as the background factors that influenced each interaction, with a view to contextualizing the theory building process (Zahra, 2007). Each interview lasted an average of about 3 h, but where necessary, we also re-interviewed important respondents. With one enterprise founded in 2002, only its entrepreneurs were interviewed for about 3 h, but in the case of another more mature enterprise, not only its entrepreneurs but also eight of its managers were interviewed a number of times. A total of almost fifty lengthy semi-structured interviews were conducted with entrepreneurs or key members of the top management teams of firms in the sample.

3.2. Sample

The descriptive characteristics of the sample in Chengdu City are shown in Table 2 below. There were a total of nine companies that were founded before or during 1997, and two that were founded after 1997. The transition period was demarcated into two distinct phases of economic transition, pre and post 1997, based on the events of that year. In 1997 the Party Congress formally recognized nonpublic ownership (an important break from Communist manifesto principles), as an important component of China's 'socialist market economy' (see Table 1). Thus the first transitional stage began with the initiation of economic reforms in 1979 and ended when the legitimacy of the market economy was officially sanctioned by the central authorities in 1997. The second stage extended from 1997 to the present, when the Chinese authorities expedited the establishment of a legal system to support the effective operation of the market economy, while correspondingly diluting the authority and use of central planning institutions.

In the Chengdu sample (whose descriptive characteristics are provided in Table 2), the oldest firm, Xinfan, was founded in 1970, and the youngest firm, Megasun was founded in 2003. The businesses ranged from traditional business sectors such as manufacturing (i.e., Pioneer in furniture production and Zhengheng in cylinder production) to modern businesses such as software development (Megasun). The descriptive characteristics of the sample in Xining City are shown in Table 3.

In the Xining City sample, six enterprises were founded before or during 1997, and four were founded after 1997. The oldest (Tibet Carpet) was founded in 1984, and the youngest (NetTrust) was founded in 2002. Six of them conducted their business in areas that took advantage of locally available natural resources, such as for example, Tibetan materials for Tibetan natural medicine. The other four were engaged in manufacturing (Newway), information technology (NetTrust and Haiwang) and energy (Tianpu). Based on the 2003 sales data, the average sales of the enterprises in Xining City were much lower than those of the sample in Chengdu City.

3.3. Analysis

We first compiled individual cases studies for each firm, particularly the process and patterns of co-operation or transaction events, and the corresponding forms of trust employed over time. Then we selected categories or dimensions that tapped the focal research questions (i.e., the forms of trust employed and changes in SME business behaviors, under evolutionary transition conditions). This resulted in the classification of our sample, separated according to temporal and locational differences. The temporal divide involved whether the founding year of the firm was in either of the two distinct stages of economic transition (i.e., pre and post 1997), whereas locational differences involved the locations of the firms in either of the two selected cities. All the 21 cases fell into four groups, based on their locations and founding years. Details of these grouping are provided in Fig. 1.

The nine firms in group A which were founded before or during 1997, and the two firms in group B which were founded during or after 1998, were all located in Chengdu City. The six firms in group C which were founded before or during 1997 and the four

Table 2
Description of sample in Chengdu City.

Company name	Business description	Number of employees	Sales in 2003 (RMB)
CCK (founded in 1979)	Specializing in development and manufacture of transformation equipment in the high-voltage grid of 40.5 kV	1000	380 million
Zhengheng (founded in 1997)	Specializing in the production of cylinders body for the automobile engines.	500	120 million
Nigale (founded in 1994)	Specializing in the development, production, and sale of blood transfusion and collection equipments	564	50 million
Ally (founded in 1996)	Specializing in the development and construction of hydrogen facilities for converting methyl-alcohol into hydrogen	80	42 million
Goldenfield (founded in 1998)	Production and sale of livestock feed, extending to animal breeding in 2003	100	40 million
Kelun (founded in 1996)	Development, production and sale intravenous medical supply.	–	2000 million
Megasun (founded in 2003)	Focusing on the development of software for the administration of mobile communication base stations	17	–
Yingge (founded in 1997)	Main product is high accuracy models – numerical control cutters	210	–
Pioneer (founded in 1985)	Furniture design and manufacture	–	–
Xinfan (founded in 1970)	Production and sale of high quality refined pickle and cucumber products.	70	–
Dragon & Tiger (founded in 1978)	Production and sale of plastic steel windows and doors	400	–

Table 3

Description of sample in Xining City.

Company name	Business description	Number of employee	Sales in 2003 (RMB)
Newway (founded in 1999)	Development, production and sales of sanitation vehicles	315	120 million
Haiwang (founded in 1994)	Engaging in multiple business, including system engineering, equipment manufacturing and PC distribution	60	40 million
Tibet Carpet (founded in 1984)	Production of a special carpet trade termed 'Tibet Carpet', dealing mainly in sales abroad	800	31 million
Jinrui (founded in 1999)	Manufacture of healthcare products with the development of local natural materials, such as sheep-placenta	34	12 million
Min-Mag (founded in 2000)	Production and sale of magnesium and other light metals via electrolysis of phosphor-magnesium ore and carnallite	–	–
NetTrust (founded in 2002)	Software development for local SMEs in its original incarnation, later centralizing its business to consultant services for digital technology for local SMEs	26	5.59 million
Zangbao (founded in 1997)	Manufacture of healthcare products with the development of local natural medicinal materials	40	–
Liyada (founded in 1995)	Production of boric acid and its derivatives	86	–
Suqinyan (founded in 1996)	Production of chemical materials such as chlorate	95	–
Tianpu (founded in 1995)	Production and sale of solar batteries to local Tibetan herders.	28	–

firms in group D which were founded during or after 1998 were all located in Xining City. Based on within-group similarities and inter-group differences, we were able to identify patterns in how the sampled SMEs varied the forms of trust employed during the different stages of transition.

4. Findings

Table 4 summarizes the identified characteristics of SMEs behaviors during the first transitional stage (i.e., pre-1978) and the subsequent second stage. We report only similarities among our four groups exemplifying the formation of system trust and the corresponding changes in the ways of doing business.

4.1. The first transitional stage (1979 to 1997)

The interviewees from all of the firms in groups A and C stated that during this early transition period, hierarchical transactions based on top-down administrative orders played an important role in their business dealings. These administrative orders and accompanying official red stamps fostered extensive co-operation with other organizations, providing the necessary technical support and managerial resources for these firms. However, not every firm was the beneficiary of such extensive co-operation. The firms that had good relationships with local government officials (viz., CCK, Dragon and Tiger, Kelun, Nigale, Yingge in group A; Haiwang, Tianpu, Zangbao, in group C) developed more rapidly. The entrepreneurs of Nigale and Haiwang were government officials before they started their respective firms. Thus, the institutional environment provided legitimacy for their firms. Moreover, their preexisting relationships also provided their firms much needed support from local governments. This facilitated many co-operative ventures with

Location	Founding Year	
	Before 1998	During or After 1998
Chengdu City	Group A (9) <i>Ally, CCK, Dragon & Tiger Kelun, Nigale, Pioneer Xinfan, Yingge, Zhengheng</i>	Group B (2) <i>Goldenfield, Megasun</i>
Xining City	Group C (6) <i>Haiwang, Liyada, Suqinyan Tianpu, Tibet Carpet, Zangbao</i>	Group D (4) <i>Jinrui, Min-Mag Newway, NetTrust</i>

Fig. 1. Clusters of sampled SMEs.

Table 4

Summary of observed characteristics of SME behaviors.

Time Periods	Samples	Behaviors
The first stage	Groups A and C	<ul style="list-style-type: none"> • Administrative orders play important roles in enterprise founding and development. • Owners/managers of SMEs establish relationships with local government officials to obtain the necessary resources and support. • <i>Guanxi</i> with government officials plays an essential role in economic transactions and enabling business' success.
The second stage	Groups A and C	<ul style="list-style-type: none"> • Owners/managers of SMEs resort to informal, relationship-based transactions. • The emphasis on relationship-building shifts from government officials to business partners. • <i>Guanxi</i> with business partners plays an essential role in facilitating valuable and safe transactions.
	Group D	<ul style="list-style-type: none"> • Contracts play an important role in transactions; but they do not matter in actual business practice. • Clients or business partners are limited to familiar friends; afraid of doing business with strangers. • <i>Guanxi</i> with business partners plays an essential role in enabling valuable and safe transactions. • Personalized transactions dominate. • Acknowledgement of the negative effects of <i>Guanxi</i> based on personal trust, especially in underdeveloped institutional environments.
	Group B	<ul style="list-style-type: none"> • Contracts become important in transactions; Act in accordance with contracts in business practices. • Clients or business partners are not limited to familiar friends; Business is also conducted with strangers by signing contracts. • Awareness and attempts to avoid the negative effect of <i>Guanxi</i> through the use of legal tools. • Impersonal transactions dominate.

local SOEs that promoted their firms' sales and R&D. From a resource dependence perspective, co-operation and support from other actors in the task environment enabled these firms to overcome resource stringencies. The other firms in these two groups that did not have founders with prior ties to officials (*viz.*, Ally, Pioneer, Xinfan, Zhengheng in group A; Liyada, Suqinyan, Tibet Carpet in group C) failed to or found it difficult to obtain the necessary administrative co-operation and resources. Therefore, their survival during this initial period was quite tenuous. Interestingly, almost all of the interviewees in these firms complained that it was practically impossible for them to obtain co-operation from other organizations, especially local SOEs, and that they had to rely on their own wits to survive. Thus, a situation that facilitated support from other better funded enterprises like SOEs and other governmental institutions in the external institutional and task environments was more nurturing for startup SMEs. In a transitional environment, this context is reinforced by personal contacts and *guanxi* connections.

During this early transition period the government still had monopoly control over the allocation and distribution of resources, as well as over social and economic development goals. Administrative orders acted as the basis for the allocation of, and access to, scarce societal resources. It was easier for individuals and organizations with administrative orders from SOEs to obtain co-operation from other organizations. In a planned economy, government hierarchy and top-down administrative orders superseded all other mechanisms in governing transactions. Once the transition was underway, the prior social relationships of entrepreneurs or members of the top management teams based on particularistic trust and *guanxi* connections were sometimes useful in obtaining administrative orders. When asked how he gained clients in the earlier period of the firm's development, Mr. Wang, the CEO of CCK (a firm founded in Chengdu City in 1979), recalled:

In our industry, orders were always obtained by competitive bidding, which is popular in a market economy; however, it was quite different from Western society. If you hoped to win a bid, one necessary condition was that you had a good relationship with local government officials. Because of this, I argue that social relationships (*i.e.*, *Guanxi*) are the most important resource.

During periods characterized by the weakness or absence of formal institutions (such as during the early stages of transition), it was essential for the managers/owners of SMEs to exploit established political contacts and be a part of the critical networks involving government officials, in order to establish legitimacy and to obtain scarce resources (Lechner et al., 2006; Ozgen and Baron, 2007; Watson, 2007). This was critical given the extensive involvement of the government in all aspects of the economy. After 1997 however, the central government strengthened and solidified the processes and institutions underlying the market economy (such as contracts, ownership and property rights, laws governing these, mechanisms for settlement of disputes, etc). Because of these developments, market transactions slowly replaced administrative orders and personal trust in economic development. Laws and contracts replaced governmental bureaucratic fiat as the guiding principles in business transactions. Consequently, the importance of government officials and administrative orders diminished (Peng, 2000).

All of the firms in groups A and C (see Fig. 1) suffered somewhat during this transition, especially those that relied greatly on administrative orders. An extreme case was Dragon & Tiger, a firm founded in 1978 to produce and sell plastic and steel windows and doors. Long after the onset of the transition process in 1979, the managers of the firm continued to rely on good relationships with local governments as a means of survival. However, with the gradual disappearance of the top-down planned economy, these government contacts couldn't help the firm, and consequently its sales decreased 30% in 1998, and these decreases continued for quite a few years. Mr. Zang, the CEO of Dragon & Tiger, seemed puzzled:

In the first twenty years, I tried to maintain good relationships with local governments, and the enterprise really benefited from it. But in the last few years of the 20th century, I found that all things had changed. The good relationships with local governments didn't bring me sales. Instead, I felt that I couldn't adapt to the new rules of the market economy. Maybe, development was just a dream for me. As long as the enterprise survived, that in itself was a big achievement for me.

4.2. The second transitional stage (1997 to 2004)

Although the market-based system still needed further improvement, the operating conditions of SMEs changed greatly during this stage, when system trust based on the market economy became more established. The surveys revealed that in contrast to the firms in groups A and C, the entrepreneurs of the firms in group B and group D (i.e., founded post 1997) were more attuned to operating businesses in a market economy. Some of them had abundant prior work experience in large enterprises. For example, Mrs. Li, the entrepreneur who started Goldenfield, had worked for about ten years in Charoen Pokphand Group's branch company in Chengdu City; Mr. Zhu, the entrepreneur from Megasun had work experience in Huawei Company before starting up the current business. Some had started up other firms before their current venture. Mr. Li, the entrepreneur from NetTrust, had built an enterprise in Shanghai City before moving to Xining City. The same was true of Mr. Huang, the entrepreneur who founded Jinrui.

In comparison with the earlier group, this set of entrepreneurs had a greater knowledge of the principles, processes and institutions inherent in a market economy. The majority of interviewees in groups B and D agreed that contractual agreements played an important role in their firms' operations. However, there were some differences between groups B and D. In relatively less developed Xining City (i.e., group D firms), firms' clients or business partners were mainly limited to their family and friends, during their firms' early startup or development stages. They were generally wary of doing business with strangers. Thus the growth of these enterprises relied to a great extent on the personal connections and network ties of the owners/managers. They relied primarily on relatively less transparent forms of particularistic trust. This was more exclusionary compared with conditions prevailing in better developed Chengdu City. However, particularistic trust based on social relationships was also a double-sided sword. While they promoted sales and reduced transaction costs, which were quite important during the early growth stages of SMEs, the sanction mechanisms in particularistic trust were not very stringent since the informal enforcement regimes were weak. Thus, personal trust could easily be exploited and abused. Confirming this, Mr. Huang of Jinrui had this to say:

Large sections of clients [were] my familiar friend[s], which ensured that my business survived in the early stages. I did appreciate their contributions at that time. However, as the business grew, some of my friends began to create trouble for me. They always delayed payments, or sometimes even refused to pay. Some contracts were just memorandums of understanding, rather than legal documents, and sometimes these contracts were not very effective. I really didn't know what I could do.

According to the two cases in Chengdu City, although the interviewees emphasized the importance of particularistic trust based on social relationships, they also indicated that they attempted to avoid doing business with familiar friends, and instead, prompted themselves to do business with strangers. These two entrepreneurs also took advantage of the existence of contracts to cover economic transactions and obtain co-operation, as well as to protect themselves against being cheated. They required friends as well as complete strangers to sign contracts in order to maintain legal protection. Mrs. Li, the entrepreneur who founded Goldenfield, recalled:

During the early stage of my business, my friends and former colleagues gave me much help. Some of them were my business's first clients; the others provided me technical advice. One year after startup, I tried to formalize the day-to-day operations. I began to ask my clients and business partners to sign legal contracts. Fortunately, this change didn't harm our friendships. To the contrary, it helped me maintain the relationships with my friends and former colleagues...to some extent, *guanxi* is not an essential component in my business now; instead, market competition is the key factor determining my business's survival and development.

4.3. The decreasing role of *guanxi* and particularistic trust

In the early stages of the transition process, with hierarchical modes of operation based on the planned economy eroding and market trust based on the market economy still under development, personal ties played a greater role in transactions. However, the goal of *guanxi* building and its use based on personal ties changed from one of gaining administrative orders (based on the institutional environment) to one of obtaining resources and reducing transaction costs in the task environment. Meanwhile, the focus of *guanxi* shifted from government officials to business partners. Thus there was a subtle shift in emphasis from seeking institutional legitimacy to an emphasis on obtaining scarce task environmental resources.

There were two main reasons for the shift. First, relationships with government officials could no longer ensure the availability of necessary but scarce resources. Instead they could sometimes constrain the firm's ability to obtain resources. These circumstances lead individuals and organizations interested in market exchanges to resort to informal, relationship-based barter exchanges with their business partners, thus accelerating the transition to a market economy. Second, with the underdeveloped state of the market system, especially the legal system, each side in the transaction found it hard to obtain legal protection. Since the enforceability of contracts was not guaranteed, the owners of SMEs were forced to conduct business with familiar partners with whom personal trust was well-established, in order to reduce their transaction risks.

System trust based on the market economy played a far greater role in more developed Chengdu City than in Xining City. Accordingly, the entrepreneurs in Chengdu City paid more attention to the rules of the market economy and they followed legally recommended rules and procedures. As a result, entrepreneurs in Chengdu City could not only take advantage of the positive benefits of personal trust based on social relationships, but could also effectively avoid their negative effects through signing contracts. They were also free to do business impersonally without any fear of being cheated, owing to the protections offered by market-based contracts.

Thus, under conditions of underdeveloped market system trust, particularistic trust served as a backup to the (still evolving) system trust, as a risk reduction mechanism. However once system trust based on the market economy was completely established, it took over the dominant role in reducing transaction risks. The mechanisms and institutions of system trust based on legal contracts and regulations mitigated the risks inherent in transactions based on personal trust. Instead of *guanxi*, contracts began to serve as catalysts for economic interactions between enterprises. *Guanxi* progressively diminished in importance, as personalized transactions were replaced by impersonal transactions.

4.4. *The adaptive strategies employed by Goldenfield: an overview*

A brief description of how one selected company Goldenfield successfully dealt with the transitions sheds some light on how entrepreneurs coped with and employed different trust mechanisms during this period. This company was launched by Li Hui, an animal nutrition and breeding major from Sichuan Agricultural University. After graduation, she joined Chengdu Charoen Pokphand, a subsidiary of the world's leading forage producer Charoen Pokphand Group based in Thailand. One year after joining, she was sent to work in the headquarters of the group in Thailand. She then went back to Chengdu City working for the same employer as a technician. Beginning in 1995, she spent three years working in another privately owned forage company as the chief technical officer. Li subsequently rejoined Chengdu Charoen Pokphand as a technician manager, specializing in research and the formulation of directions for premix.

This extensive work experience enabled her to embrace a market-oriented business philosophy besides allowing her to develop strong professional relationships with many researchers in Sichuan Agricultural University. These researchers encouraged her to resign from Charoen Pokphand and establish her own business. She recalls:

I had worked in Charoen Pokphand Group for many years. I had developed good relationships with many clients; but the most important thing was that I knew how to conduct business in this industry. When I started up my current business, I was dubbed the 'employee queen' in the forage industry in Chengdu City. From the beginning I planned to incorporate formal operating processes in my business; even with my familiar clients, I would ask them to sign contracts for each transaction. I believed that doing this would not only benefit me, but also benefit the existing relationships.

The company was established in 1998 to produce premix for forage production. It experienced rapid growth with 1998 sales topping 1 million RMB, which then spurred to 5 million RMB by 2002. Such rapid growth was partly accomplished through help from Li's researcher friends in Sichuan Agricultural University. For example, during the startup stages the company sponsored five PhDs, researchers in veterinary medicine and nutrition at Sichuan Agricultural University, to mentor and provide training to customers on breeding processes and techniques. Initially, the co-operation between Li and the Sichuan Agricultural University researchers was based on their good personal relationships stemming from particularistic trust. According to Mrs. Li:

At the beginning, it was quite difficult for me. I didn't have enough money to promote sales, but I had to exploit the market, even compete with my former employer in the local market. I suggested signing contracts to my friends. But they all refused because they trusted me. But with the business's expansion, once the company had accumulated more money, my friends and I agreed to sign contracts. Because of these changes, the co-operation evolved to another level involving links between my company and Sichuan Agricultural University.

Subsequently, because profit margins in forage production declined sharply to 5 to 6%, the company began to survey new business opportunities. The Ma goat project (i.e., the fostering and breeding of a special species of goat) was recommended to Mrs. Li as a potential opportunity by her researcher friends. Ma goat was one of the seven varieties included in the State's gene trait reserves. Due to the lack of specialized fostering and breeding facilities, the amphimixis among Ma goats resulted in the loss of the Ma goat gene. It became a priority to preserve the gene. With the support extended by experts, friends, and government leaders, Mrs. Li, despite her relative ignorance about the subject, decided to enter this business. Recalling the process, she said:

In those days, my researcher friends encouraged me to enter this business, and they gave me lots of valuable advice about the market potential of this project. Without these words of encouragement, I wouldn't have entered this business, and the company wouldn't be as successful now.

The project proved to be successful with 2004 sales increasing to 40 million RMB and evolved to a co-operation between the two organizations, Sichuan Agricultural University and Goldenfield. Initially, an animal gene research institute was established as a special research and development department in the University. It was subsequently registered as a privately owned entity affiliated with the company, with Li Hui being the legal administrator of the institute and the researchers being primarily teachers and students of Sichuan Agricultural University. The company made the necessary investments, including arranging for financing and for supplying the goats needed as experimental subjects. The goat breeding guide group from the university also directed the work of the breeding center of the company. The company could make full use of the technological resources, the equipment (a gene test machine worth millions of RMB was made available for Li's company to borrow, as long as the university also had access to it) and the human resources of the university. Students in the university could utilize Goldenfield as an experimental site.

The corporation provided funding for the students in gene testing, sample collection, sample analysis, data analysis and anatomization. Commenting on the co-operation with Sichuan Agricultural University, Mrs. Li said:

The faculty and I had good private relations, we trusted each other; but on the other hand, I didn't worry about whether they would betray these co-operative relationships because the institute provided me with the legal protection. Therefore, the risks were greatly reduced. I believed the business would be more successful through the combined efforts of the two sides.

During the startup stage, the entrepreneur's friends informally provided information and knowledge to Goldenfield, which considerably reduced the company's initial costs and transferred the necessary technology, management skills, and other support, as documented in the entrepreneurship literature ([Markman et al., 2005](#)). After 2002, by which time the company had reached the second take-off stage and market institutions had become more established, the entrepreneur utilized system trust to ensure the university's continued support for the company's Ma goat breeding business. Goldenfield and Sichuan Agricultural University then jointly set up a research institute, successfully employing systems trust and market principles.

5. Conclusion and discussions

A major theoretical insight provided by the study is how changes in the forms of trust applicable during extended periods of institutional transitions reshapes business behaviors with adaptation occurring to the new rules of the game, regardless of what historical and previous cultural traditions have dictated. Based on trends towards a greater market-orientation in most Confucian societies, we predict that *guanxi* will progressively lose its importance in business transactions, once the transition to a market economy is well advanced or has been completed. This corroborates the evidence available from the more well-developed economies of the West ([Zucker, 1986](#)).

The role and importance of *guanxi* is evolutionary and somewhat different from that evidenced when viewed in a static perspective. *Guanxi* becomes relevant primarily because it facilitates business transactions during transitions. System trust based on well-established institutions is absent during the early stages of economic transitions. Established institutions are fundamental requirements for establishing systems trust in a market economy.

In a planned economy, power and authority devolve from the Communist Party hierarchy and structure. Almost all the SMEs founded during these earlier stages of transition paid a great deal of attention to building *guanxi* (based on personal ties) with governmental officials, as a means to obtaining top-down administrative orders, so that they could mobilize necessary resources and do business with external partners. These administrative orders served as catalysts promoting trust production between unknown persons. However, the access to these administrative orders was not equal among organizations and people. It was restricted for those who did not have the necessary political connections with central or local government officials.

During later transitional stages, system trust based on market institutions became more established. The usefulness of administrative orders from the State owned institutions diminished. As a result, *guanxi* with governmental officials lost its importance. Instead all SMEs began to take advantage of *guanxi* with business partners instead of with governmental officials as a means to substitute for the underdeveloped state of formal market institutions. SMEs in relatively well-developed economic areas like Chengdu City in Sichuan Province relied to a greater extent on contracts and legal protections as a means of doing business, both with strangers as well as with familiar partners. Improvements in market institutions were absolutely necessary for entrepreneurs to begin relying on contracts instead of on personal trust in business dealings.

The findings have two implications for theory. First, they underscore the importance of applying a contingent perspective when studying the value of *guanxi*. The importance of *guanxi* in Chinese business practices was primarily the result of the underdeveloped state of formal institutions. This importance diminished over time with the establishment of market institutions, with less concern over what historical and cultural traditions dictated. Thus the continued importance of *guanxi* in business transactions is a moot point, as observed trends towards greater market practices and institutions play out in transitional economies. It is important to adopt a longitudinal and process-based perspective in order to account for the institutional and other contingent factors that might constrain or enable entrepreneurs to take advantages of *guanxi* in business transactions. In keeping with the methodological recommendations made by multiple authors in entrepreneurship ([Coviello and Jones, 2004](#); [Gartner and Birley, 2002](#); [Zahra, 2007](#)), this study uniquely juxtaposes convergent insights from multiple perspectives like institutional and trust theories on a large, dynamic and epochal setting like China's economic, legal, social and political transformation lasting over the past three decades. Moreover, our research moves beyond merely describing observed phenomena to providing explanations for them based on theory, one characteristic of exemplary qualitative research in entrepreneurship noted by [Gartner and Birley \(2002; p. 393\)](#).

Consonant with [Zucker's \(1986\)](#) contention that the push for systems trust has largely been completed in Western Societies, our study illustrates that system trust is necessary for economic development in modernizing societies. Furthermore, we also illustrate the role that particularistic trust plays as a bridge accompanying and influencing ongoing institutional transitions. Thus exploring the interaction and balance between system trust and particularistic trust will be more helpful in understanding business behaviors in transitional economies, rather than merely focusing on their unique cultural traditions.

5.1. Future research opportunities

More studies in other transitional economies are required to extend the generalizability of our findings, which are based on case studies in China. Future research could also devote more attention to exploring contingencies under which guanxi becomes either an asset or a liability. To what extent does guanxi contribute towards improving business performance? Hitherto most literature has viewed guanxi favorably? What about bad guanxi that is associated with favoritism, nepotism, unfair competition and fraud (Fan, 2002)? All of these practices are either unethical or illegal, and contrary to the principles of fair and transparent market competition. Guanxi violates the 'arms length principle' that no personal or family relationships should play a role in free market economic decision-making (Zucker, 1986). Guanxi also discriminates against people outside of the social network, which is against the principles of fairness (Zucker, 1986). Given all of the above, it behooves future research to avoid adopting an overly positive view of guanxi.

In addition, since Guanxi has widely been used as a strategic (or tactical) weapon in managing environmental uncertainty, its role and value, as well as how it is used, may depend on the stage of transition. Rather than passively reacting to environmental condition, managers and entrepreneurs also proactively enact their environment (Tan and Tan, 2005). Thus, incorporating the time dimension may offer added insights.

5.2. Implications for entrepreneurship and managerial practice

There are implications for managers/owners of SMEs in other transitional as well as developed economies. Managers/owners of SMEs should build business philosophies appropriate to the rules of the market economy. Social relationships based on personal trust are quite important for the early survival of SMEs. However, the greatest impediment to the further development of these SMEs could lie in the tendency of entrepreneur/managers to rely exclusively on their successful experiences from the past, as documented in other contexts (Lechner et al., 2006). Sometimes these entrepreneurs become overly dependent on the benefits accruing from social relationships based on personal trust. This may constrain these SMEs from developing beneficial relationships with other organizations (Lechner et al., 2006). While received theory suggests that guanxi networking among overseas Chinese business groups in Southeast Asia contributed greatly to their success (Redding, 1990), more recent evidence suggests that even among these successful overseas Chinese business groups there have been behavioral modifications necessitated by the need to adapt to the changing rules of economic competition (Gomez, 1999).

The entrepreneurs and managers of SMEs should take greater advantage of market institutions and the nascent legal systems being established as a protection against fraud or against being cheated. Private enterprises in China have already adopted a variety of coping strategies involving combinations of both personal and system trust, such as granting government officials 'power shares' in return for political protection, forming business associations, cultivating patron–client ties, and adopting 'red hat' strategies (Chen, 2007).

Guanxi, and by extension of other forms of personal or particularistic trust derived from networks, is instrumental to entrepreneurial opportunity identification and exploitation, new firm formation, and value creation (Ardichvili et al., 2003). Guanxi provides entrepreneurs the ability to obtain relevant information on government policies, market trends and business opportunities (Fan, 2002). This information helps entrepreneurs formulate better, more realistic business plans. It is otherwise difficult for startup companies to obtain this type of information, because of the time and expense involved in conducting environmental scanning, analysis and forecasting. The social capital embedded in the guanxi network enables entrepreneurs to reduce transaction costs and thus enhance their efficiency (Carlisle and Flynn, 2005; Fan, 2002; Zhang and Zhang, 2006). This can help offset a critical disadvantage faced by most startup businesses. Guanxi also enables entrepreneurs to obtain resources like business licenses, land, physical assets, critical supplies, lower cost capital, access to market or distribution channels, and even product endorsements (Fan, 2002). Finally, for small firms, guanxi provides legitimacy (Carlisle and Flynn, 2005). Legitimacy ensures that the actions of the startup are viewed as desirable, proper, and appropriate within a socially constructed system of norms, values and beliefs. This is critical in China, where for smaller organizations, the threshold required for legitimacy is higher and more difficult to achieve, than it is for either SOEs or for TVEs (Carlisle and Flynn, 2005).

The relative mix between particularistic trust and systems trust would be based on the individual characteristics and repertoire of skills possessed by the entrepreneur (Lee and Venkataraman, 2006), the background and nature of the business partners, the age and history of the enterprise, the characteristics of the industry, the geographic location, and the stage of the economic transition process (Dew et al., 2004; Sarasvathy, 2004). Appropriate combinations of all these relevant factors could result in the emergence of a self-reinforcing 'virtuous cycle' of entrepreneurship (Venkataraman, 2004). The enterprises' need for legitimacy or the need for resources, industry specific factors such as regulatory stringency and resource stringency may also influence the relative amounts of attention devoted to the institutional or task environments (Oliver, 1997).

Even in developed economies, as organizations mature and grow in size and scope, there is a tendency to gravitate from informal, personally-based modes of managing to more formal structures, modes of strategy-making, systems and control processes (Greiner, 1998). This is especially true when industries are undergoing periods of restructuring, transformation, or upheaval. Likewise, the entrepreneurship literature also traces the sub-stages of small business development (Churchill and Lewis, 1983). Some of what we observed in our Chinese SME sample may reflect this maturation process that firms inevitably undergo, irrespective of context. However, previous research has primarily studied organizations in developed economies with stable, well-established institutional environments. We build on this earlier work by superimposing institutional transitions on the ongoing organizational growth and maturation processes. In summation, as our findings clearly indicate, entrepreneurs and managers of

SMEs need to employ a greater variety of formal and informal coping mechanisms to deal with the abstruse and unpredictable changes that the environment presents, under such transitional conditions.

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