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**Article**

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Hailan Yang, Stephen Morgan\*

## **Development of China's State-controlled Firms. The Case of the Consumer Electronics Sector\*\***

The aim of the paper is to investigate the development of China's state-controlled firms in the consumer electronics sector, where we focus on the evolution of firm business strategy and ownership structure, two aspects of a firm's internal organization crucial for competitive advantage. The Chinese consumer electronics sector is used for the study, partly on the basis of its significance in national economy, but also because its growth experience is typical of many industries in the Chinese economy as a whole. This paper uses case studies to identify the specific characteristics of China's firms that operate in a transitional society undergoing social and economic transformation. It is argued in this paper that there exist different ways of development of China's state-controlled firms with different competitive position.

**Key words: development, state-controlled, China, qualitative research**

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## Introduction

China's state-owned enterprises (SOEs) have experienced radical transformation during the transition from a planned economy to a market-oriented economy over the past three decades. At the end of 2009, 1604 large enterprises had become listed firms on the Chinese stock exchanges of Shanghai or Shenzhen (Shanghai Stock Exchange 2009; Shenzhen Stock Exchange 2009). More than 70 percent of the listed firms are state-controlled firms in which the state is the largest shareholder (Securities Daily, 20/12/2009). Although the state owns a majority of the stake, many of state-controlled firms have been given some market or market-like incentives (World Bank Group 2001). Such newly acquired autonomy and flexibility have motivated the state-controlled firms to build resources and capabilities to compete.

Development of business strategy and appropriate form of ownership structure are two of the major internal means to achieve the competitive advantage of the firms (Child/Pleister 2003; Filatotchev/Toms 2003). Past empirical studies have largely neglected the link between institutions, business strategy, ownership and firm performance in a transition economy such as China. Changes in these elements may influence the degree of strategic fit between the choices of firms and their external environment. An examination of the interaction between various internal and external elements helps enrich our understanding of the processes that influence the growth of the state-controlled firms in China during the transition period.

Our focus on only one industrial sector – the consumer electronics (CE) sector – enables us to minimize the influence of industry and technology on the management attitudes and organizational behavior of the firms. Different industrial sectors will display different characteristics regarding the adoption of market orientation since they operate under different conditions and with varying degrees of government regulations (Deng/Dart 1999). The focus on one industry avoids conflicting conclusions based on the aggregate discussion of various industries.

This study integrates exploitation-exploration framework with the institution theory to propose a dynamic strategic fit of the firms in a transition environment. The formation of a firm's strategies is dependent on the environment in which the firm operates. The matching of strategy and environment can obtain better performance—a poor match can hurt performance (Miller 1988). Business strategy is a necessary but not sufficient condition for performance. Performance is also influenced by the ownership of the firms (Filatotchev/Toms 2003). The appropriate ownership structure is seen as the means to better enable the managers to exploit strategically, firstly the internal resources of the firm, and secondly position the firm to better explore external resources, thus to improve the performance of the firm (Jefferson/Su 2006; Thomsen/Pedersen 2000).

Here the following questions are asked: how does the exploitation and exploration construct apply in the China's state-controlled firms in CE sector? and how do the state-controlled firms in China evolve their ownership structure? It is the aim of the paper to investigate the development of China's state-controlled firms using case studies of firms in the CE sector, where we focus on the evolution of firm business strategy and ownership structure, two aspects of a firm's internal organization crucial

for competitive advantage. The study is organized as follows. First, the institutional situation in the Chinese CE sector is provided. Second, different ways of development of firms are described, followed by the description of exploitation and exploration learning strategy in transition economies. The fourth part deals with the efficiency of the state ownership. Next the research design is explained. Part six focuses on findings on strategy and ownership evolution of the case firms and followed by its discussion. It is concluded with a summary of the theoretical implications and future research.

### **The institutional situation in the Chinese consumer electronics sector**

The CE sector in China has been one of the fastest growing industrial sectors during the past three decades. It has experienced many changes in production, market composition, firm behavior, ownership structure, and the level of government intervention (Jiang 2001). For this reason, the sector is broadly representative of the manufacturing sectors at large in the process of economic transition.

The development of China's firms in CE sector has evolved through two broad stages with the 1993 making a turning point, when China's State Council issued '*Decisions on Some Problems in Establishment of Socialism Market Economic System*'. Since the start of economic reforms in 1978, the government has sought to improve the management and performance of SOEs ([www.China.org.cn](http://www.China.org.cn), 07/11/2003). During the first stage, the reform aimed to grant SOEs more autonomy by allowing SOE managers increased authority over the allocation of their profits and decisions about production (Naughton 1995). Shanghai and Shenzhen stock exchanges were opened in 1990 and 1991 respectively. At this stage, however, the state-owned distribution organizations were highly rigid and inefficient for manufacturers. For the CE sector, this meant that the sales of products was centralized and the companies did not have their own distribution outlets. Consequently, the firms were unable to respond to changing customer needs promptly and flexibly (Simon 1992). The increasing misfit between the distribution system and consumer demand led some firms in CE sector to adopt corresponding business strategies to rectify the problems in economic system.

The year 1993 was a watershed for the conversion of China's SOEs because central government initiatives spurred on a more supportive economic and social environment that provided incentives for firms to engage in technological learning (Xie/Wu 2003). Both central and local governments became less directly involved in commercial activities and further deregulation of production and circulation of products. The control rights over state-controlled firms were gradually devolved from the central government to local government. The decentralization of economic authority triggered increased competition. Accordingly, the manufacturers had more freedom and willingness to innovate according to market liberalization, competitive pressure, and consumer demand (Jefferson/Su 2006; Song/Yao 2003). In addition, the government allowed international firms easier access to the Chinese market. The entry of new firms – not only foreign-invested but ostensibly private-owned firms – intensified competition in the CE sector (Jiang 2001). Although the government was deeply involved in bailing out large, failing state firms, such cases were more exceptions than the norm. Increasingly, only in extraordinary circumstances do state firms obtain such support from the government (Jiang 2001). Increased market competition, globaliza-

tion and technological innovation have reshaped the competitive landscape of the state-controlled firms (Tan 2005).

### **Different ways of development of firms**

The development of business strategy and the appropriate ownership structure are major internal means to achieve the competitive advantage of the firms (Child/Pleister 2003; Filatotchev/Toms 2003). According to debates on the development of the firms, two schools of argument have come into being: the ownership school and the management school (Qu 2003). The 'ownership school' argues that the form of ownership – and especially its reform – is the key to the development of the firms. State ownership is held to be intrinsically less effective than private ownership mostly because politicians force state-controlled firms to pursue political goals or other social objectives rather than profit maximization. Therefore the key to the reform is to diversify state ownership, in order to eliminate government control of the firms. Not so the view of the 'management school', which emphasizes the need to improve the management of the firms, such as the development of a market-oriented strategy without the shackles of state demands (Liu/Garino 2001b). This school of thought does not believe there is anything intrinsically inefficient about state ownership itself. Ownership of the firm is an irrelevant concept if a firm is regarded as a Williamsonian nexus of contracts (Fama 1980). State-controlled firms are not different from those listed firms in market economies that have wide spread public ownership, and a firm's performance depends on their management culture and the clarity of goals and objectives (Chang/Singh 1997; Wortzel/Wortzel 1989). Therefore, according to management school, the solution for the inefficient of the state-controlled firms is to grant the firms more managerial autonomy and adopt more commercially oriented business strategies (Liu/Garino 2001b), which would positively influence future performance. In this article, we investigate the ways or processes of development of state-controlled firms by discussing business strategy and ownership respectively, and how these influence their performance.

### **Exploitation and exploration learning strategy in transition economies**

Strategy is commonly understood as the means by which a firm adapts its internal organization, goals and resources to the demands of the external market environment in ways that enable it to compete effectively with rivals (Baron 1995). A firm's specific strategy selection is based on the careful evaluation of its unique resource portfolios (Barney 1991). All firms face common organizational challenges: they begin with an initial complement of resources and capabilities at their founding, and over time as products and markets change, they have to acquire the additional resources and capabilities to remain competitive and survive. Two distinct ways of developing the resource and capability base of the firm are exploitation and exploration strategies (March 1991). Surviving in a transition economy often requires that firms pursue a dual strategy that attempts to balance the need to leverage their current competencies and resources, which is a strategy of exploitation, while preparing to acquire resources anticipated for the future through a strategy of exploration and experimentation (Wiseman et al. 2006). Both activities consume scarce resources, which require

organizations to set explicit decision-making policies for allocating the resources available for resource renewal (March 1991).

Exploitation is a strategic renewal process aimed at leveraging existing firm-specific assets by improving them or by improving their use. It includes matters such as refinement, choice, selection, efficiency, implementation and focused attention (Crossan/Lane/White 1999; Hitt/Lee/Yucel 2002; Holmqvist 2004; Levinthal/March 1993; March 1991). Exploration, by way of contrast, is a strategic renewal process that seeks to acquire new firm-specific assets (March 1991). It entails activities such as search, variation, risk-taking, discovery, innovation, and research and development. Based on these two definitions, exploitation is a requirement for implementing an advantage-seeking growth strategy, while exploration is needed for succeeding in opportunity-seeking growth (Caldart/Ricart 2007). Meyer (2007: 1500) highlighted the challenge for firms of such strategies in transition economies: 'Exploitation learning refers to the pursuit and acquisition of knowledge, which is new for the companies in a transition economy, but already in existence in the West. Exploration learning is the creation of new knowledge to develop strategic flexibility, leading to sustainable competitive advantage.' According to Masini, Zollo, and Wassenhove (2004), turbulent environments require continuous adaptation. The choice between exploitation and exploration is important in a dynamic transition environment: better matching of a firm's strategy and the environment make for better performance, and vice versa (Miller 1988).

Exploitation and exploration strategies are complementary, despite the acknowledged tension between the two. Although exploration primarily involves the acquisition of new knowledge from external sources, it may involve the novel combination of existing technologies and know-how within the firm. Levinthal and March (1993: 105) observed firms must engage in both strategies: 'An organization that engages exclusively in exploitation will ordinarily suffer from obsolescence. The basic problem confronting an organization is to engage in sufficient exploitation to ensure its current viability and, at the same time, to devote enough energy to exploration to ensure its future viability.' Striving for a balanced focus would appear desirable for businesses operating in complex environments such as a transition economy.

### **The efficiency of the state ownership**

Business strategy is a necessary but not sufficient condition for firm performance. The structure of ownership also influences performance. It affects the motivations of managers in making decisions that have cost and benefit implications (Fee/Hadlock/Thomas 2006).

The ownership structure that has emerged in many Chinese listed companies is unique. Large corporations that were wholly state-owned have been partially privatized during the transition, resulting in a mixed ownership structure with varying proportions of equity retained by the government, either directly or indirectly (Lu/Yao 2006; Megginson/Netter 2001; Megginson 2005). Besides the straightforward government direct control, where the state exercises control via its ownership of the controlling non-listed parent company, ownership vested in related state entities enables indirect control. The government uses a control chain including state solely owned

companies, state-controlled non-listed companies, state controlled publicly listed companies and state-owned academic institutions to control listed firms (Liu/ Sun 2003). Control is further exercised through the state's prerogative to appoint the senior management and the chair of the board of directors and supervisory board. The main feature of the structure of listed Chinese firms is the dominance of state, which ultimately controls these companies.

Searching for uniform superiority of either private or public enterprise is an objective that has eluded past research (Kwoka 2005). One key debate is whether state ownership is generally associated with inferior performance (e.g. Bai et al. 2004; Gunasekarage/Hess/Hu 2007; Qi et al. 2000; Sun/Tong 2003; Wei et al. 2005). There are three main reasons believing state ownership impairs performance. The first one has to do with the non-profit-maximizing behavior of state ownership. Governments are interested in realizing political and social concerns such as maintaining employment (Shleifer/Vishny 1994). The better the financial shape of the firm, the easier for the state to pursue these goals external to the firm. This may adversely impact on firm performance (Li/Sun/Zou 2009). The second reason is that state ownership is considered to possess significant agency costs. The de facto absence of owners in the firms increases managerial discretion in a potentially adverse way because the monitoring of managers is more difficult in state-controlled firms (Agrawal/Knoeber 1996; Jensen 1986; Jensen/Meckling, 1976). Unlike the Anglo-American model of dispersed shareholding ownership, where shareholders exercise control through election of directors and annual meetings, the mechanism to discipline managers is wanting if not absent. Thus state ownership is incompatible with the managerial structure of modern firms in terms of ownership efficiency. Thirdly, state-controlled firms do appear to face especially soft budget constraints, that is, they are propped up with government support for political or social reasons. Such firms can lose money in larger quantities and over longer periods of time without exiting the industry than private firms (Ballou 2005). The soft budget constraints distort incentives for firms, inducing inefficient allocation of resources and market-irrational economic behavior.

On the other hand, there is considerable evidence that the long-standing debate over the relationship between ownership and performance may require some rethinking (Kwoka 2005; Tian/Estrin 2008; Wang 2005; Whitley/Czaban 1998). Most of the studies providing evidence for the relation existing between ownership and performance rely on the assumption of exogeneity, which means that ownership is external or outside the nature of the firm (Goergen 1998). The relationship between ownership structure and firm performance is insignificant when controlling for endogeneity of ownership structure (Demsetz/Lehn 1985; Demsetz/Villalonga 2001). The endogeneity problem arises when ownership is chosen as a function of performance or as a function of unobserved variables that also affect performance. In other words, ownership has been justified in terms of a series of factors within the firm itself, inherent to the area of industry or sector in which it operates (Leech/Leahy 1991). Research on ownership endogeneity concludes that ownership is not due to value maximizing behavior, but rather determined by the circumstances or factors of the firm such as its contracting environment, size, the inherent riskiness of the assets, or its performance (Demsetz/Lehn 1985). The state-controlled firms in many countries are less competi-

tive not because they are owned by the state, but because of the lack of explicit goals and objectives and state demands that can compromise the pursuit of efficiency and profitability (Heracleous 2001). It is unreasonable to suppose that ownership per se has an impact on profit maximization (Demsetz 1983).

## Research Design:

### Case study, performance measurement and data analysis

This study is based on longitudinal and cross-sectional case studies (Yin 2007). It spans the period from the initiation of economic reforms in 1978 to 2007. There were two steps in the collection of information for this study. First, the secondary sources of information such as company reports and published information in both the Chinese media and Western media were reviewed. Based on these data, a list of questions was developed, focusing on strategies and ownership. Second, 26 semi-structured interviews were conducted with senior managers and board members in the case companies, government officials, and professionals in order to achieve triangulation. The profile of the interviewees is outlined in table 1.

**Table 1: The list of interviewees from organization**

Organisation	Interviewee No.	Interviewee role	Years with Co.	Years in current post	Date of interview
S1	1	Non-executive director	15	8	04/2007
	2	Senior manager	12	11	04/2007
	3	Non-executive director	23	8	04/2007
	4	Executive director	11	5	04/2007
	5	Senior manager	18	8	04/2007
	6	Senior manager	12	11	04/2007
	7	Independent director	N/A	6	04/2007
	8	Senior manager	18	10	04/2007, 05/2008
	9	Senior manager	25	5	04/2007, 05/2008
	10	Non-executive director	9	9	05/2008
	11	Executive director	28	4	04/2007, 05/2008
	12	Senior manager	16	10	05/2008
S2	13	Independent director	N/A	7	05/2007
	14	Non-executive director	27	13	05/2007
	15	Executive director	30	5	05/2007
	16	Senior manager	30	4	05/2007
	17	Non-executive director	25	4	05/2007, 06/2008
	18	Senior manager	15	5	06/2008
	19	Senior manager	23	5	05/2007, 06/2008
	20	Board secretary Executive director	18	4	05/2007, 06/2008
Other	21	Deputy director in Policy and Regulation Office	3	3	07/2007
	22	Senior consultant in Securities Co.	14	14	07/2007
	23	Senior consultant in Consulting firm	15	15	05/2007
	24	Vice president in Electronics Bureau	10	34	07/2007
	25	Assistant to general manager in Asset Management Co.	5	5	04/2007
	26	Senior manager in Securities Co.	12	12	04/2007

The interviews were conducted during the years 2006-2008. The first round of interviews was conducted during five months between March and August 2006. The second round of interviews was conducted from April to July 2008. The 20 interviewees of the case companies were senior executives, board members including executive directors, non-executive directors and independent directors. In addition to the company informants, six non-company persons were also interviewed. The six people were from the local government, an asset management company, a securities company and a consulting company.

The adoption of different types of business strategies and ownership structure of the cases was conducted in different phases. Therefore the questions related to the earlier period were normally answered by the interviewees who worked in the company for a long time, covering the different stages of the development of the firm. The selection of informants was aimed at collecting data from those who were in a good position to be informed about the firm's business strategies and ownership structure. Each interview was conducted in Mandarin and, on average, took around two hours.

Two cases were analysed in some depth. The cases in the study were purposive, rather than random. The two firms were selected since they represented *prima facie* two extremes transformation of state-controlled firms. The names of the cases are represented by S1 and S2, whose main business is televisions. They used to be stand-alone factories wholly owned, managed and operated by various levels of government. After undergoing corporatisation, they proposed for an initial public offering for listing on Shanghai stock exchange in 1997 and 1996 respectively. S1 was established by the government in 1969 and is a dominant player in the Chinese market for CE sector. In the face of the fierce competition in the market, S1 seemed to be changing rapidly towards the market-oriented reform. Founded in 1936, S2 has experienced success and crisis during the recent past. As the earliest electronics enterprise in China, S2 used to be a large and leading SOE in the CE sector. However, the transition towards a market economy has brought huge institutional change in China. S2 demonstrated a slow pace of change towards the increasingly competitive market, which made it uncompetitive with other domestic firms.

The analysis of S1 and S2 is divided into two stages with 1993 making a watershed. Since S1 and S2 were not listed until 1997 and 1996 respectively, they were referred to as SOEs before listing and state-controlled firms after listing.

### ***Measuring performance of the firms***

Two variables of performance of firms are examined in this study – market share and the growth rate of annual sales. In developed nations, accounting profit and stock returns are two of the major indicators of a company's financial performance. However new strategies and competitive realities demand new measurement systems (Eccles 1991). There is a shift from treating financial measures as the foundation for performance measures, to placing these non-financial measures such as quality and market share on an equal footing with financial performance measures (Stainer/Heap 1996). Other authors (Johnson/Kaplan 1987; Kaplan/Norton 1992) lay out arguments against judging performance based solely on financial criteria.

Jiang (2001) points out that not all the major changes in the Chinese economic development can be accounted for from the perspective of the economic system. For instance, falling profitability may result from the emergence of competition from the non-state enterprises, which is a desirable effect of economic reform (Jefferson/Rawski 1994; Naughton 1995). Competition has caused government-monopolized profits to drop. A drop in the profitability of the manufacturing industry is an inevitable stage in reform. But this does not mean that reform has failed to improve efficiency (Jiang 2001). Moreover, managers have both the incentive and discretion to manipulate the financial account. For example, the profit figures have been inflated or fabricated by the management to support the stock price (Feinerman 2007). Firms have also shown a loss in order to obtain a subsidy from the government. In order to avoid the misleading conclusions based on potentially unreliable financial data in the Chinese context, this study assesses the performance of the firms that is measured by the market share and growth rate of sales of the companies.

Market share refers to the percentage of the overall volume of business in a given market that is controlled by one company in relation to its competitors. The important factor in computing relative market share is not the exact number associated with the sales volume. The position relative to the competition is more important (Cook 1995). It is easier to measure than some other common objectives, such as maximizing profits. Ambler and Wang (2002) compare the performance measures employed in China and UK and find that more Chinese respondents than UK considered market share as an important marketing metric. The focus on market share results from the transition to the era of hyper competition in China. Facing the increasing intensified competition, market share became more concentrated during 1990s (Schlevogt 2000). That firms in China may improve their production efficiency is driven by increasing market share of their products (Brandt/Zhu 2005).

However, a company may be tempted to set too low a price to achieve higher market share. To remedy the weakness of market share, the second competitive position indicator chosen is the growth rate of the annual sales. Information on a firm's relative market share should be correlated with the growth rate of the firms. If both the company's competitive position and growth rate are strong, then the company occupies a fortunate position and is known as a 'star' (Urban/Star 1991).

### ***Data analysis***

Cross case analysis is used to detect similarities and compare differences among cases. At an early stage, the analysis focused on within-case analysis. The overall idea is to become intimately familiar with each case as a stand-alone entity. This process allows the unique patterns of each case to emerge before investigators generalize patterns across cases (Eisenhardt 1989). The interviewees' descriptions were carefully perused to develop a broad picture of the firms, their main activities, and their economic and administrative environment. Next, following prescriptions for grounded theory building (Locke 2001), a search was made for common categories across cases (Ravasi/Zattoni 2006). Selecting categories and then looking for within-group similarities coupled with inter-group differences are keys to good cross-case analysis (Eisenhardt 1989). The third step was to conduct cross-case analysis based on within-case analysis.

This step aimed to looking at within group similarities and intergroup differences. In a further round of comparative analysis, combining within-case analysis with cross-case comparison, the article explains differences in the observed patterns across business strategies and ownership structure.

## Findings: Business strategies, ownership structure and performance of the case firms

### *Exploitation and exploration strategies of case firms*

The development of the firms in the area of business strategies has experienced two major stages, from 1978 to 1993, and from 1993 to 2007 (Table 2). Change in the business and institutional environment required change of the firms to obtain new resources and capabilities. During the reform period, the strategies of the managers and their complement of resources and capabilities have changed dynamically. S1 has made great strides in terms of adapting to the market, thus making it possible to raise productivity and efficiency. S2, however, has been slow or unable to adapt to the evolving market conditions and its competitive position has slipped.

**Table 2: Stages of firms' pursuit of business strategies**

		S1	S2
Stage 1 (1978—1992)	<b>Institutional Factors</b>	The existence of government support for the SOEs but the support was declining; increasing competition in domestic and broad market	The existence of government support for the SOEs but the support was declining increasing competition in domestic and broad market
	<b>Business Strategies</b>	<b>Exploitation:</b> acquire knowledge through alliances from buying patents and licensing to establishing joint ventures <b>Exploration:</b> create distribution network	Heavily dependent on government. No positive learning strategies
Stage 2 (1993—2007)	<b>Institutional Factors</b>	Government has begun to further relinquish control over the state controlled firms; Increased market competition, globalization and technological innovation	Government has begun to further relinquish control over the state-controlled firms Increased market competition, globalization and technological innovation
	<b>Business Strategies</b>	<b>Exploitation:</b> further expanded distribution network; International partners and 'buying in' <b>Exploration:</b> technical centres; locate re-search centres in advanced counties; R and D on quality enhancement	Heavily dependent on government. No positive learning strategies

### *Stage 1: 1978-1992*

The exploration strategy of S1 during this period was mainly centred on sales and distribution, which grew rapidly as managers became more attuned to the workings of the market. Market knowledge and high degree of operational flexibility can be achieved through business networks (Interview 5). The distribution routes owned by firms would achieve two positive outcomes. First, unlike state-run distribution activities, the distribution channels owned by the firms themselves were consumer focused by necessity and encouraged firms to generate improvements in quality, pay greater attention to consumer needs, undertake better warranties and repair services, make greater efforts at sales promotion, and develop new product varieties to meet market

needs. Second, the strong commitment to understanding and working with this distribution system helped prevent problems that arose in different regions and symbolized a commitment to the Chinese market (Interviews 3, 5).

During this stage, S1 began to build its market knowledge through interaction with customers and the creation of extensive distribution networks. S1 was one of the earliest firms in the sector to build a nationwide system of provincial sales offices. Senior management from S1 believed that during the early stage of development creating a distribution network to acquire market knowledge was more practical than developing advanced technology independently, as the latter required heavy investment and faced high risk (Interviews 8, 9, 11). As one senior manager from S1 (Interview 11) claimed:

Contrary to the developed market where firms must rely on research and development and strong products to be competitive, in China the technology inherent in the products was similar. We began to build up our understanding of Chinese consumers and their purchasing habits through creating our own distribution network. Thus the advantage of the distribution channels explained to some extent the good performance of some firms.

The sales network of S1 reduced its distribution costs and enabled them to compete better on price. Until the early 1990s, S1 was a relatively unknown firm. In 1992, the second year following the establishment of its own distribution channels, the output of its main business, color TV sets, exceeded 1.4 million sets, ranking the firm fourth among the TV producers in China (Interview 3). This boosted S1's image in the market.

With high technological turbulence and tight budget constraints, to stay ahead of competitors technologically was not an easy task. At this stage, S1 broadened its R & D activities in order to support their marketing activities. Since the huge cost and high risks involved in the development of new products were extreme in the early phase, the firms that had limited resources were unable to afford to explore extensively (Interview 8). The ability for a firm to obtain knowledge faster than its competitors was a key component of its competitive advantage in the first stage. Consequently, cooperation with the multinational corporations (MNCs) was often identified as proper strategies to acquire technology.

These collaborations with MNCs enabled the S1 to acquire the technology quickly and reduced the stigma of lagging technology being attached to their brands by Chinese consumers. As early as 1984, S1 had entered into collaboration with Matsushita to acquire colour TV technology. Subsequently other collaboration agreements were signed between S1 and foreign companies (Interview 11). Although buying technology from foreign firms was a common practice, S1 bought only advanced technologies from Western countries. Senior managers of S1 considered that this would be more effective when competing with local firms and in catching up with MNCs. When facing the choice of buying technology from a Hong Kong firm for US\$1.5 million or from Matsushita for US\$3 million in 1992, S1 chose to buy from Matsushita, which had the more advanced technologies (Gao 2007).

Unlike S1, S2 was less eager to cooperate with firms from advanced countries for technology and paid less attention to distribution channels (Interviews 15, 29). The company had a substantial aviation and defence electronics business producing for

state-owned clients in addition to consumer lines. S2's managers lacked incentive mechanisms to reorient their operations toward consumer needs. As a consequence of its privileged government supplier role, managers were more inclined to resort to government support when faced with sales and profit decline rather than develop an effective business strategy (Interview 24).

### *Stage 2: 1993-2007*

During the second stage, senior managers from S1 believed that independent distribution channels remain crucial for them. They expanded their distribution network, which has given them increasingly broader geographical coverage compared with other domestic producers. By the end of 2006, S1 had 200 branches and more than 10,000 sales and service outlets throughout China covering all provinces and major cities (Asia Port Daily News, 04/01/2007).

Expansion of S1's distribution network and sales-and- service activities supported decision making in their marketing and product design activities. S1 incorporated feedback and experience of users obtained from its distribution channels and marketing departments into product design and innovation efforts in its business-level R & D centres (Interviews 1, 8).

The management of S1 further identified technology and innovation as the focus of its new strategic development at this stage, essential for growth in the CE sector, which is characterized by rapid changes in product features, functions, and performance. However, S1 found it difficult to leverage its technologic knowledge without controlling key complementary assets (Interview 2). Over-reliance on a 'buying in' strategy had not allowed it to develop what the literature would consider a stable and efficient manufacturing process (Katz 1997; Miller 1990). As an interviewee from S1 (Interview 6) explained:

The technology suppliers from Western countries are not always usually willing to disseminate core technology to us. The firm can only acquire some medium or low-level technology in this way.

S1 had accumulated and upgraded its resources and capabilities in the first stage, which in turn enhanced its innovative activities and investments at the second stage (Interview 2). From the mid-1990s, S1 had embarked on establishing an internal R & D capability in addition to the import of technology.

Since over-production of the consumer electronics products has forced the market price down to the detriment of producers, S1 felt that it could demand a price premium which was good for the profits. Rather than being content to play in the conventional business segment, it was seeking the higher margins of new technology and making a leap forward in consumer electronics through technology (Interview 23). Its first attempt was to lay a solid foundation for the manufacturing of high-tech products. S1 invested in manufacturing capabilities and establishing large-scale manufacturing plants. S1's Technical Park had more than 1,500 staff, 11 professional institutes, five sub-developing centres and a postdoctoral R & D working station by the end 2007. In the early-2000s the company also began to locate its research facilities in Japan and US, where the world's cutting-edge technology was being developed. S1's strategy was to build an international brand name in the toughest developed markets

from which it can gradually expand other markets. S1 became a leader in its respective area (Interview 12).

However, S2's managers still resorted to government support and help when S1 continually increasing investment in R & D and innovation. The extent of the relationship networks with the government that S2 managed to build up overtime was one of its most striking features. The dependence of S2 on the government made it unresponsive to market changes. The comments of a S2 interviewee (Interview 20) were illustrative:

You cannot imagine the intricacy of relationship web of [S2] in the government. It will be unbelievable if [S2], one of the earliest and ever most famous SOEs is closed down.

In 1996, S2 was the premier competitive domestic colour TV manufacturer in China. S2 lost over one third of its market share in China in 1998. By the early 2007 S1 took over S2's position as a leading TV maker in terms of market share (Interview 21). S2's survival was no longer possible without government support. Yet as one of the largest companies in the province and one of the earliest national brands in China, the government was reluctant to close it despite continuing losses. The state pledged that every attempt would be made to assist S2 to overcome its financial plight (Yu 2005), which in turn weakened the incentive of the managers to adopt positive learning strategies to achieve economic benefits.

### ***The evolution of ownership structure of case firms***

Until the early-1980s, S1 and S2 were stand-alone factories wholly owned, managed and operated by various levels of government. Above the factory was a complex array of government agencies that administered every aspect of the factory. Both control and ownership was vested wholly in the state. In effect, they were not companies in a western sense, but rather a set of administrative production and distribution units subject to the direction of the Chinese State (Groves et al. 1994; Jefferson/Rawski 1994). The employees and managers had few incentives to maximize profit or efficiency under such conditions (Chow 2002). Managers therefore, did not have autonomy over production decisions and wage determination.

With the deregulation of government policy in CE sector, central government decentralized its control rights over the state-controlled firms to local governments. In the context of the Chinese transitional economy, political promotion of the local leaders is closely related to the economic performance of the region (Walder 2003). Local governments have incentives to provide more autonomy to firms provided they are profitable. This has seen the decentralization of the control rights to managers that allow them to implement market-based decisions that improve competitive capability of the firms. The competitive firms in turn help the local governments to fulfill their economic goal. During the years following S1's initial listing in 1997, the largest shareholder in S1 was the local government in the area in which it was located that at one time accounted for 70 percent of total shares (S1 Annual Report 1998). These state shares were not publicly traded in China and another 10 percent were held by related state parties. Only about 20 percent of issued shares belonged to individual shares and it were these that could be traded freely on the market. Compared with 1997, the

ownership structure of S1 had changed greatly and the ownership concentration reduced.

The concentration of state ownership in S1 was reduced from 74.07 percent in 1997 to 48.4 percent in 2007 (S1 Annual Report 2008), though that still means only about half the issued nominal stock of shares were traded on the market. One of the independent directors of S1 (Interview 7) elaborates as follows:

[S1] is a new form of state-controlled firm. Its operational mechanism including acquisition of the resources and the assessment of the employees is market-based. Even if [S1] is state-controlled, its owners and CEO are driven by performance incentives and objectives, such as profit maximization or market share maximization.

With the decentralization of the ownership from the central government to the local government, the local government is able to make a residual claim, while more decision-making power has been delegated to them as well (Fan 2005). Local government has placed more attention on the economic development of the firms. Decentralization provided incentives to the managers of the firms. Managers interviewed from S1 said that under local government ownership the government would be dependent on the performance of local firms for economic benefits (Interviews 5, 6, 18). The dependence of local government on the performance of S1 gave the firm more bargaining power, which in turn provided incentives to the managers. The managers of S1 have gained great autonomy despite the ultimate control of local government. In this situation, the S1 does not subsume its profit motive under other requirements such as employment and social welfare. Although state controlled, ownership and management were increasingly separated in practices as seen in the increased autonomy of decision making without recourse to government approval. One of the independent directors of S1 (Interview 4) elaborates as follows:

The government now hardly intervenes in the business of the company. The board has much more decision-making power nowadays. Although the most important decisions require consultation with the state-authorized organizations... the local government would accept the recommendation of the board as long as it thinks they are reasonable and can improve the local economy.

In contrast, the state ownership in S2 remained unchanged since its first listing (S2 Annual Report, various years). Since 1998 the firm has been trapped into financial trouble, but it has enjoyed significant preferential treatment from the government (Interview 14). The government rescued S2 through an agreement instead of closing it down. S2's special status (aviation-defence electronics producer) and its large scale brought a higher level of direct State-Party control and a corresponding higher level of state shareholding and reluctance to relax control over the operations of S2. State ownership always remained 54.2 percent since it listed in 1996. For S2, the state's need to guarantee its survival is greater than the need to guarantee returns on capital (Interviews 21, 24).

### ***The performance of the case firms***

Table 3 indicates the domestic market share of each case respectively. S1 has a prominent share of their domestic market segment and ranked among the top five for mar-

ket share from 1995 to 2007. S2's market share dropped from 9.7 percent in 1995 to 5 percent in 2007 (Chinese Household Electronics Report, various years).

**Table 3: The firms' domestic market share, 1995-2007**

	1995 (%)	2000 (%)	2003 (%)	2007 (%)	Ranking by product market share (2007)
S1	2.94	10.91	11.11	16.23	1
S2	9.7	3.79	3	5	N/A

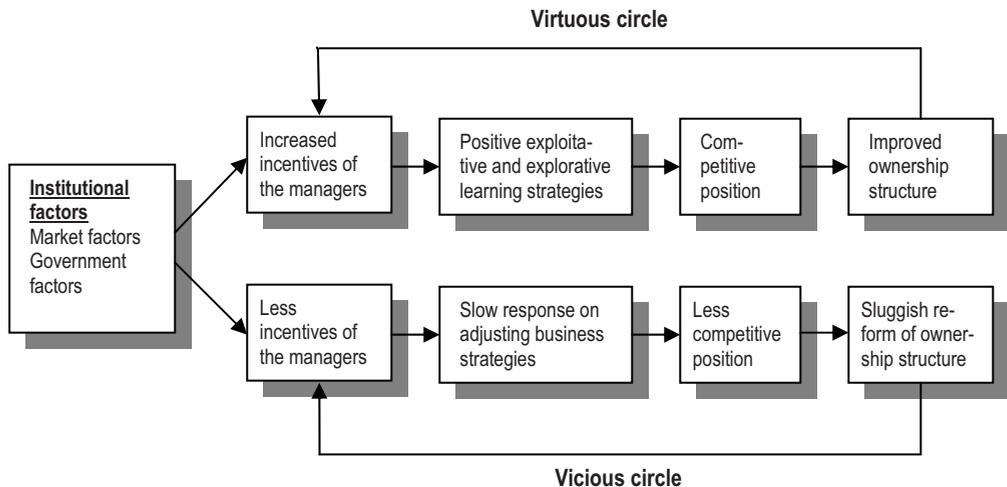
Source: Chinese Household Electronics Report (various years)

S1's growth rate of main business sales was 25 percent in 2007, far above the average growth rate of 17.2 percent in the similar filed (S1 Annual Report 2008). The negative growth rate of main business sales of 10.44 percent in 2007 of S2 disabled it to compete with other manufacturers (S2 Annual Report 2008).

**Discussion – state ownership and competitiveness**

Chinese state-controlled firms in terms of their competitive position are neither inevitably less competitive nor more competitive than firms that have other types of ownership forms. Competitive state-controlled firms such as S1 were able to grow and expand continuously their market shares, while the less competitive firms such as S2 have found survival increasingly tough going. We can explain these differences in terms of a virtuous circle of positive feedback in response to market stimulus or a vicious circle of defensive and negative feedback that reinforced anti-market orientations associated with their administrative heritage before the advent of economic reforms. Figure 1 shows our model: the competitive state-controlled firms created a virtuous circle of their development while the less competitive firms became trapped in a vicious circle.

**Figure 1: The two ways of development of state-controlled firms**



*The virtuous circle of the development pattern of state-controlled firms with competitive position*

For the firm S1, the virtuous circle of development is associated with a more market-oriented external environment that increased the incentives for managers to develop their business. Increased incentives for the managers to pursue profit-seeking goals enabled the managers to become more market- and learning-oriented in their business strategies, which in turn led to the firm adopting a more competitive position and resulting in better performance. Since such competitive firms helped the government to achieve their economic goals, through employment and taxation, the role of the local government in these state-controlled firms has shifted from direct administrative control of firms to an indirect role of guidance. This shift has benefited management's decision making and responsiveness to the market. It has also allowed for the ownership structure to become more diversified and property rights more clarified. This in turn further strengthened incentives for managers to focus on the competitiveness of firms in the market thereby initiating another iteration of a virtuous cycle.

The emergence of competitive markets and decentralized government control are two striking features of transformation in the CE sector. Since the emergence of the buyer's market for products where competition is the rule, product market competition has been associated with a relatively high degree of managerial autonomy, which has provided incentives for firms to improve their production efficiency. The findings also suggest that recently, the government has started to value the market-disciplining function implicit in public listing and reduced their interference in the firm that might affect performance. Central government gradually streamlined its internal economic sections and shifted the decision rights to the local government, which then shifted the rights to business enterprises.

What makes local government different in the transformation period is that local government officials mainly depend on performance of local businesses to demonstrate and valorize their own capabilities. Correspondingly, the local government was motivated to allow firms it oversaw to adopt strategies that are more independent provided there is a credible expectation that the strategies can induce faster growth of firms and higher sales than would be the case if the government intervened in firms. Local government therefore devolved to the management of the firms the rights to devise and implement strategies so as to encourage response to the market and maximize the value of the firm. The residual claims were thus transferred from local government to the manager. According to Walder (1995: 270), 'governments at the lower levels are able to exercise more effective control over their assets than are governments at higher levels.' This decentralization of rights promotes sufficient competition to constrain government intervention in state and non-state firms.

The incentives derived from the environmental dynamism of this institutional transition compel the firms to be learning-oriented in their business development. If the firms were able to respond to the dimension and pace of institutional change, such newly acquired autonomy and flexibility motivated the firms to design strategies to build resources and capabilities to compete. Motivated by profit, the managers responded enthusiastically to opportunities for growth. Since the firms play an increasing role in the managerial decision-making during China's economic transition, the man-

agers exercised the freedom required to design and implement the business strategies necessary to satisfy their target customers. The analysis shows that the firms became learning-oriented in order to survive the fierce competition. The changes of the business strategy over time reflected their adaptability to the changing structure and opportunities of the market. The analysis shows that in the context of the business environment discussed above, the business strategies of the firm were determined by the incentives for the managers. The firm itself was transformed through a series of learning behaviours that sharpened its competitiveness.

This study holds that the better performance of a firm such as S1 would lead to dilution of state ownership. Seemingly, the better the performance of the firm, the less concentrated is the ownership of the firms. This is consistent with the idea of Kole (1996) that corporate performance could influence the ownership structure rather than being determined by ownership structure.

However, this is not a simplistic argument to infer that ownership determines firm performance in a unidirectional way; we need to take an explicit account of the mutual links between firm performance and the ownership. Superior performance may lead to lower concentration of ownership of the firms. Since S1 provided substantial benefits to local government it was more successful in improving its bargaining power, which provides it with leverage to resist interference from the local government. In general, the greater the firm's bargaining power, the greater its ability to reduce government interference. The growing indispensability of the firms has contributed to their influence and created a new power balance in favour of firm managers. When it comes to business decisions, the prestige and reputation of the firms usually carries weight in decision-making as long as local government officials believe their strategies are sound. Accordingly, government relinquishes its majority stake in the S1 as maintaining ownership becomes increasingly counterproductive in a competitive marketplace. Decentralized ownership structure gave managers more control and more rights to claim residual income, which established appropriate incentive mechanisms related to firm performance thereby starting another iteration of the virtuous circle.

#### *The vicious circle of the development pattern of state-controlled firms with competitive position*

For the firm S2 there were fewer incentives for it to adopt market-oriented strategies and it became trapped in a vicious circle of reliance on state support, which reduced its competitiveness over time. S2 had expected the past model of business operation would still work in a fast changing market: governmental authorities or agencies, rather than the market, would primarily determined the fate of the firm. Although the level of government intervention was reduced, S2 was poor in adapting to the market and continued to seek protection from the government. Thus its managers lacked the incentive to adopt positive learning strategies to grow the firm. S2 had weaker aspirations to exploit opportunities in the external environment and to develop production, technological and organizational capabilities, which meant it was less inclined to engage in learning-oriented strategic activities. Sticking to old strategies in changing environments may lead to poor performance and undermined the firm's competitive position (Audia/Locke/Smith 2000).

Although S2 was less competitive than S1, it was very large and the government wanted to retain a majority shareholding in such a state-controlled firm to prevent it going out of the business. Interference from the government in S2 strengthened as its performance worsened, which further impaired the incentives of the managers. The firm was unable to seize the opportunity provided by the changing institutional and market environment thereby initiating another iteration of the vicious cycle.

## **Conclusion: Theoretical implications and avenues for future research**

### *Theoretical implications*

This study is exploratory. It seeks to explore the ways of development of China's state-controlled firms in the transitional China. Since the beginning of the reform in China, polarization has emerged among the state-controlled firms. Some have grown and continuously expanded their market shares, while the less competitive ones have found the survival from the fierce competition increasingly tough.

Three contributions emerge. First, in discussing the business strategies, the study identified the processes by which the firms are able to maintain dynamic strategic fit in a changing environment. Our research explicitly incorporates this dynamic perspective into the study of the fit between firms and their changing institutional environments. Second, our analysis has shown the dominant view that state-controlled firms are associated with fewer positive learning strategies should be reconsidered. State-controlled firms are not all alike. Managers of competitive state-controlled firms in general have more managerial autonomy than do managers of less competitive state-controlled firms, and act in a more entrepreneurial and market-inspired competitive spirit. Third, the evidence found in the cases in the context of China's transition economy is not a repetition of the dominant theory that the strategy configuration is directly influenced by the ownership type an organization takes (Tan 1996, 2002). This article argues that the state-controlled firms are not necessarily less positive in taking exploitative and explorative learning strategies than the firms with privately-owned type of ownership. In this light, private ownership is neither a necessary nor sufficient condition for market-oriented learning strategies. The cases studied in this research constitute a potent challenge to the widely held view that private ownership is an indispensable prerequisite to market-oriented learning strategies.

### *Avenues for future research*

This study is not free of limitations, particularly owing to its exploratory nature. The limitation is common to any case study, that is, the reliance on a small sample. For this limitation, this part proposes the need for further research related to the following broad issues.

First, future research should consider the generalizability of the findings of this study to firms in other transition economies. In fact, in many ways it is difficult to compare the cases of firm reform in China with those in Eastern Europe and the Soviet Union, not only because of the different approach but also because of the very different historical, economic and cultural contexts (Buck et al. 2000). To further assess its distinctiveness, the practices of China's firms in these two areas and their antecedents should be compared to samples of companies in other countries.

Second, the sample of firms in this article is limited to the large-sized ones in their category of ownership type. However, the nature and outcomes of small and medium-sized firms in China might produce results that differ from the findings in this study. For example, the political effects of local government organizations on firms of different sizes might be significantly different. It will therefore be important to extend the analysis to firms of different sizes in China.

China has a diverse, complex and rapidly changing economy. This study suggests that China's experience with enterprise reform differs from what might have been suggested by mainstream management literature. The CE sector we have argued is representative of the manufacturing industry in China's transition to the market economy. Quite a few of the front-runners in this sector are state-controlled firms. If the experiences of these firms are extrapolated to other state-controlled firms, Chinese state-controlled firms as a whole may continue to maintain their competitiveness, despite the importance of the market for China.

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