

XUEYUAN ZHANG

Strategizing of Foreign Firms in China

An institution-based perspective



STRATEGIZING OF FOREIGN FIRMS IN CHINA:
AN INSTITUTION-BASED PERSPECTIVE

Xueyuan Zhang

STRATEGIZING OF FOREIGN FIRMS IN CHINA: An institution-based perspective

Het formuleren van een strategie van buitenlandse ondernemingen in China:
Een institutioneel perspectief

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To my parents

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After four and a half year of tough but enjoyable working, I finally have my completed Ph.D. thesis in front of me. Back in 2003, when I decided to pursue a Ph.D. in business administration, my intention was to gain competence in conducting research in that field. Now, I am so glad that I can present my achievement by means of this thesis. While enjoying the happiness, I am well aware that this achievement is not solely out of my own hard work, it would not have been possible without the contributions of so many others.

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1 Introduction

China has started to assume a prominent position in the world economy since the beginning of economic reform and the introduction of the open-door policy in 1978. Be it represented as a miracle or a threat in the media, the fact is that China has not only maintained a high growth rate but also successfully integrated into the world economy in the past thirty years. From 1979 to 2006, the average annual growth rate of China's real GDP reached more than 9%. Total imports and exports increased from US\$ 20.64 billion in 1978 to US\$ 1760.7 billion in 2006. China's vivid and rapidly growing economy contrasts significantly with those of most other transition economies. In this course, foreign direct investment (FDI) has made a significant contribution. China has experienced a rapid inflow of FDI and has been the largest recipient of FDI among developing countries since 1992. Realized FDI increased from US\$ 57 million in 1978 to US\$ 69.5 billion in 2006. The number of approved foreign invested enterprises reached 594,445 by the end of 2006 from virtually zero in 1978. Consequently, the proportion of exports from foreign invested enterprises in China's total exports continues to increase, reaching 58.2 percent in 2006; while the proportion of imports destined for foreign invested enterprises in China's total imports was 59.7 percent in the same year. China has become the "workshop of the world" where foreign firms bring in raw materials and parts, manufacture products, and export them internationally. Made-in-China consumer goods dominate shop shelves in western countries, while industrial goods are shaping the next wave (Boston Consulting Group, 2003). This is best reflected in the acquisition activities of Multinational Corporations (MNCs) in China's machinery industry over the past three years. By the end of 2005, more than 400 MNCs from the Global 500 have invested there, and more than 40 MNCs have established a regional headquarters in China. Intel, for example, established a greater China headquarter independent of its Asia-Pacific headquarters on 1 January 2007, which reports directly to the global headquarter in the US. It is clear that China remains a most attractive destination for FDI and that foreign-invested enterprises are one of the major players in the "Made-in-China" story.

There are some interesting features, however, that warrant closer analysis of the behaviour of foreign-invested enterprises in China. First, while an increasing number of foreign investors establish their businesses in China, the institutional environment there is often regarded as uncertain, which is assumed to generate higher transaction costs of doing business there (World Bank, 2005). Second, it appears that foreign investors, by going to China, attempt to not only explore a huge market and exploit low-cost production factors, but also increasingly are amazed by the upgraded supply chains within China (Deloitte Consulting, 2003, 2007). While these technical factors induce them to enter China and relocate their businesses globally, foreign investors have to tackle the complex, idiosyncratic institutional environment in order to safeguard their operation's success (Clissord, 2004; Khanna et al., 2005). The economy of China is informed by its long history and rich culture and is also characterized by dynamism and diversity within the country today. A gradual approach towards the development of a market economy has naturally given rise to many transitional institutions (Qian, 2002). At the national level, policies concerning FDI have been streamlined with the aim of gradually establishing the rule of law as the basis of the relationship between government and business (International Finance Corporation, 2000; OECD, 2005). The promulgation of a Property Rights Law in March 2007 ensures the protection of property rights for the first time since 1949. However, the implementation of central policies is often met with local conditions and interests that are sometimes incompatible. As a consequence of decentralization, local governments not only have the authority to interpret and implement central policies according to local conditions, but also tend to expand their duties and focus on rent-seeking activities (International Finance Corporation, 2000). The findings, as presented in this dissertation, point out that foreign-invested enterprises have learnt to navigate the uncertain waters of economic transition in China: (1) Foreign-invested enterprises evolve over time to adapt to the dynamic institutional environment in their strategic and organizational choices; (2) Their ownership preferences are subject to adjustment both on entry and in operation, and entail a learning process regarding local institutions and their interactions with local governments; (3) Foreign-invested enterprises, in addition, actively develop political strategies at the *local* level, and collaborate with local governments at both macro and micro levels, offering them sufficient cooperation rents (i.e. political leverage) that help to mitigate uncertainty and risk in the non-market environment and thus facilitate their market-oriented operations.

These findings suggest that the survival and success of foreign-invested enterprises in China is not merely based on their market strategies but also, and more so, based on the integration of their market and non-market strategies. They

have to organize effectively both inside and outside the firm in order to achieve harmony with local governments and (informal) institutions. The learning effect may have made foreign-invested enterprises more inclined to become embedded in local networks, which play a larger supportive role in economic exchanges when the formal institutions are weak. Businesses thus hope to survive the uncertainty in China's economic transition. Therefore, localization proves to be the most suitable choice for their success and today reflects, not only their attempts to cope with the "Chineseness" of the environment, but also their attempt at "going local".

1.1 Motivation

This dissertation is a response to the call for attention from both strategy research and international business studies to institutions in China and other emerging economies (Child and Tse, 2001; Narayanan and Fahey, 2005; Shenkar, 2004; Tseng and Foster, 2006; Wright et al., 2005). The growing importance of emerging economies such as China's is reflected in the upsurge of research on the topic in both streams in recent years. Scholars argue, on one hand, that "there is a need to consider the extent to which theories and methodologies used to study strategy in mature, developed economies are suited to the unique social, political, and economic contexts as well as firm characteristics of emerging economies" (Wright et al., 2005), and, on the other hand, that focusing on firms operating in such a unique context offers the high potential to contribute to the extant body of knowledge (Tsui et al., 2004).

Therefore, scholars suggest that an institution-based view, bringing institutions to the analytical window, is needed in studying firms' strategies (Oliver, 1997; Peng, 2002; Wright et al., 2005). Strategy research, originating in developed countries, largely focuses on Western firms and takes a market-based institutional environment for granted (Peng, 2002). From this perspective, industrial conditions (Porter, 1980) and a firm's resources (Barney, 1991) are taken as primary determinants of performance. Thus the relationship between business strategy and the institutional environment is left at the background. Firms operating in emerging economies such as China face a different set of rules from those in developed economies. The institutional environment engenders "a set of political, social, and legal ground rules that establishes the basis for production, exchange, and distribution" (Davis and North, 1970). It is made of both formal institutions (e.g. rules and laws) and informal institutions (e.g. socially sanctioned norms of behaviour) (North, 1990; Scott, 2001). Recent strategy research identifies a lack of a market-based

institutional environment in emerging economies, which challenges conventional wisdoms in both theory and methodology (Hoskisson et al., 2000; Wright et al., 2005). As a consequence, strategies based on industry conditions and firm resources can not generate expected outcomes in emerging economies where firms operate according to a different set of rules (Khanna and Palepu, 1997). As a result, firms need to develop strategies that work around an institutional void (Khanna et al., 2005).

To tackle the issue of how institutions matter to strategizing, we need to examine firms and behaviours in different institutional settings (Scott, 2001). Previous studies show that transition economies in particular provide examples of institutional difference. Under such a situation, firms' behaviour is not as expected according to conventional wisdom (e.g. Stiglitz, 1999). Therefore and as "the most foreign of all foreign places" (Chen, 2001), the Chinese case is very valuable for the study of the interaction between institutions and organizations. Further, China's economic transition has shed much light on institutional complexity and diversity as theorized in network capitalism (Boisot and Child, 1996), hybrid market economics (Nee, 1992) and local corporatism (Walder, 1995; Oi, 1995). This implies that China presents an ideal research laboratory of institutions.

The above features of China in transition suggest that a focus on China will improve our knowledge about international business as well. Internationally, competitive advantage is found "in the synergetic combination of global and local knowledge", but regrettably, "the field as a whole has come to play down the value of such expertise" (Shenkar, 2004). Location-specificity plays a critical role in international business as economic integration in reality falls far short of the ideal of total integration (Ghemawat, 2003). In order to avoid "running out of steam" (Buckley, 2002), the field needs to re-embrace its own competitive advantage (Shenkar, 2004). While the field's focus is on international business success and failure, context-specific research needs to be reemphasized much more in order to bring local knowledge into analysis and feedback further into theory development. Previous theoretical probings into transition economies have shown the significance of institutions to the strategizing of foreign-invested enterprises in those economies (e.g. Child and Tse, 2001; Meyer and Peng, 2005). Empirically, scholars have made greater attempts to study organizations in China; however, according to the number of scholarly articles published, China remains one of the least studied regions in the world (Tsui et al., 2004).

Why study foreign-invested enterprises? China's economic transition is characterized by the development of organizations and more organizational diversity. Ownership proves to be an illuminating and promising variable for strategy research

(Peng et al., 2004). Different ownerships are subject to different institutional constraints, leading to different strategic and organizational choices (Peng, 2003; Peng and Heath, 1996; Peng et al., 2004). Previous studies show that collectively-owned enterprises (such as township and village enterprises) and private enterprises attempt to seek collaboration with the government in one way or another, such as getting local governments involved in corporate governance (Che and Qian, 1998) and seeking a “red hat” (a kind of political status or linkage) for the firm (Chen, 2007) in order to cope with complexity in the institutional environment. In comparison, the experience of foreign-invested enterprises is arguably more enlightening, since they enter the market with their own routines and norms, but must cope with local institutions particular to China if they hope to succeed (Boisot and Child, 1999; Peng, 2003). Their strategizing deeply reflects the interaction between institutions and organizations. Taking foreign-invested enterprises (*foreign firms* hereafter) as our research object, we refer to the subsidiary level, since foreign subsidiaries, instead of their home corporations, are the most appropriate level to study their interactions with local conditions in China (Birkinshaw, 1997; Blumentritt and Nigh, 2002). Given the growing importance of China in the world economy, improved knowledge about international business strategy thereof has enormous practical applications for foreign firms entering and operating in China (Child and Tse, 2001; Peng et al., 2004).

1.2 Major Theoretical Issues

The substantive purpose of this dissertation is, from an institution-based perspective, to address various theoretical issues of international business strategy regarding the interaction between institutions and foreign firms in China, i.e. dynamics of isomorphism in foreign ownership, a process approach to ownership choice, and managing the firm-government relationship.

Dynamics of isomorphism in foreign ownership. Recently, scholars have used institutional theory (DiMaggio and Powell, 1983; Scott, 2001) to explain the ownership choices of foreign firms in host countries. Empirical studies show that foreign firms tend to converge in their ownership modes under isomorphic pressures from the institutional environment in order to gain legitimacy (Lu, 2002; Yiu and Makino, 2002). These studies take institutions as a given. However, institutions may be “less evitable than institutional theory suggests” (Oliver, 1992), and therefore, changes in organizational patterns often occur “when legal or other rule-maintaining

boundaries are relaxed” (Powell, 1991). In addition, firms may not be as passive as institutional theory suggests. From a strategic perspective, an ownership form is deliberately selected to enhance efficiency and competitiveness (e.g. Anderson and Gatignon, 1986; Barkema and Vermeulen, 1998; Hennart, 1988). While institutional constraints represent external forces influencing organizational choices, the strategic perspective provides the additional logic of internal managerial discretion. When institutional changes occur, firms often seek new forms to achieve competitiveness and deviate from established conformity, leading to dynamics of isomorphism in the organizational population. Yet, little attention has been devoted to this dynamic phenomenon with a few exceptions (e.g. Haveman and Rao, 1997; Kraatz and Zajac, 1996). Do foreign firms in China present dynamics of isomorphism in their ownership pattern? This dissertation aims to answer this question by integrating the strategic perspective into institutional theory.

A process approach to ownership choice. Ownership choice is one crucial element of foreign firms’ strategy in a host country. From an individual perspective, firms select an ownership mode based on transaction costs, values, and/or institutional constraints. However, empirical studies return inconclusive findings (e.g. Chen et al., 2002; Delios and Beamish, 1999; Guillén, 2003; Kogut and Singh, 1988; Malhotra, 2003; Yiu and Makino, 2002). This is largely due to the weakness of the variance approach adopted in these studies. A few studies have demonstrated the variety of possible trade-offs (costs vs. values and efficiency vs. legitimacy) in ownership choice (e.g. Luo, 2001a). However, a variance approach is unable to specify the interplay among different determinants and thus the underlying process therein. In practice, what we observe as the ownership form of a firm may not be what they desire to have, which may (partly) cause the inconsistent or inconclusive empirical findings. Therefore, Gomes-Casseres (1990) suggest a need to consider “what a foreign firm desires to have” and “what a foreign firm can do” separately in two phases. A process approach has the merit of identifying the underlying sequence of events leading to a decision (Langley, 1999; Mohr, 1982), but few such studies have been conducted (e.g. Büchel, 2002). In China, in particular, the ownership preference of foreign firms, based on transaction costs and values, is confronted with many local constraints other than central regulatory policies (Faure, 2000). This dissertation attempts to explore the learning process in which foreign firms adjust their ownership preferences through direct interactions with local institutions in China.

Managing the firm-government relationship. In practice, strategizing the firm-government relationship is a challenge for firms (e.g. Watkins, 2003), especially foreign firms (i.e. foreign subsidiaries) that operate in transition economies (e.g. Peng, 2003). International business studies have attempted to explain the relationship between foreign firms and host governments as either conflicting or cooperative (e.g. Fagre and Wells, 1982; Dunning, 1998). However, results fall short of explaining the behaviour of foreign firms in their attempt to influence the institutional environment. Recent developments in the study of political strategies (Hillman and Hitt, 1999; Bonardi et al., 2005) provide us with another lens for looking at the issue. Political strategists emphasize the attractiveness of a political market in which “demanders and suppliers transact over public policies” (Bonardi et al, 2006). The demanders include firms and organized interests groups, while the suppliers are composed of elected politicians, regulatory agencies and courts. Non-market performance is influenced by rivalry among demanders or suppliers, and by a firm’s ability to mitigate political transaction costs. Therefore, this political strategy perspective highlights the significance of government to the non-market environment, and helps to explain how firms develop means to influence government and public policy decisions thereby mitigating uncertainty (Baron, 1995; Bonardi and Keim, 2005; Rugman, 1998). Although international business scholars have acknowledged the political behaviour of foreign firms in host countries (e.g. Boddewyn and Brewer, 1994), firm conclusions remain scant (Hillman and Wan, 2005). Few studies of the political strategies of MNCs have insightfully begun to model the relationship between government and firms with the subsidiary as the level of analysis (Blumentritt and Nigh, 2002; Hillman and Wan, 2005): these studies analyze the *national* government as the counterpart of foreign firms rather than examining the particular role of *local* governments. Scholars of transition economies, especially the Chinese economy, argue that this is inappropriate (e.g. Krug, 2004; Walder 1995). This dissertation aims to explain why and how foreign firms manage their relationship with local government in China from a political strategy perspective.

1.3 Methodological Issues

Our substantive purpose is to examine the influence of local context on the behaviour of foreign firms in China. It requires contextualizing the existing knowledge, i.e. understanding the institutional setting where firms operate (Rousseau and Fried 2001; Tsui, 2004). Entering and operating in China, foreign

firms face not only weakly enforced and transitional market institutions but also various specific institutional constraints (e.g. ownership regulations and industry barriers) at the national level (Luo, 2002b). In addition, the institutional environment appears to be heterogeneous across regions since *de facto* fiscal decentralization sees much political and economic decision-making power delegated to the local government level (Krug, 2004; Krug and Hendriscske, 2005; Qian and Weingast, 1997), beyond which, there are substantial regional differences in language, identity, factor endowment and economic development. Interjurisdictional competition drives local governments to focus on developing and improving the investment climates (e.g. Dollar 2003; KPMG 2003) and opening more development zones in their jurisdictions to host foreign firms with preferential policies (Qian, 2002).

Foreign firms tend to register and locate in such zones in order to capture institutional advantage (Zhang and Reinmoeller, 2007; Zhou et al., 2002). Development zones are important institutions in the FDI sector in China. After the open-door policy was introduced, China established four Special Economic Zones (SEZs) to host foreign firms and one reason was to isolate the impact of foreign ownership in the socialist system. SEZs proved to be successful in attracting foreign firms (Park, 1997). In SEZs, foreign firms were subject to more liberalized policies than elsewhere. Over time, an increasing number of local governments adopted this model and it was (and is) often the case that development zones (including SEZs) are endowed with better physical infrastructure. There was also usually less state intervention and the additional entitlement to tax privileges. Crucially, local governments have tended to develop economic policies through their interactions with foreign firms.

This dissertation uses various methods to address the major theoretical issues outlined above. An econometric method is applied to study the dynamics of isomorphism in foreign ownership, while a case-study method is used for the other two theoretical issues that are more explorative. In our econometric analysis, we empirically test how institutions in China determine the dynamics of isomorphism in the population of foreign firms. The analysis is based on a panel database including data from 15 provinces during the period 1984 – 2003 (300 data points in total). By the end of 2003, the total number of foreign firms approved for establishment reached 465,277. Our panel database includes 332,062 foreign firms which account for 71% of the total number of foreign firms that entered China in the period of the study.

To explore the behaviours of foreign firms at the local level, we can not simply rely on statistics. We therefore select a multiple-case study method to address the

issues of ownership choice and firm-government relationship management. A *case study* provides us with a theory-building opportunity: by exploring the business and non-business behaviours of firms, it becomes possible to place crucial events and the relationships among variables in their context. It emphasizes “developing constructs, measures and testable theoretical propositions” (Eisenhardt and Graebner, 2007). Multiple cases help to establish the “replication” logic (Yin, 2003), by which we can examine the robustness of the original findings and thus generate propositions for future research.

We studied thirty foreign firms in total over a three-year period in six cities in eastern China, which were Suzhou, Hangzhou, Shanghai, Wuxi, Shenyang and Dezhou (especially focusing on the first three cities). Statistics show that the eastern provinces host 82% of foreign firms in China (China Ministry of Commerce, 2005). The Yangtze River Delta, where Suzhou, Hangzhou and Shanghai are located, is also the location of numerous development zones (China Association of Development Zones, 2005), so it is theoretically insightful to select cases from the region. Since we aim to draw insights from case studies, we do not describe population characteristics along a single dimension; the “local” features of our cases do not matter (Manion, 1994). Among the thirty firms we study, twenty-eight operate in one of the development zones.

Data collection for case studies. Data was collected through interviews and the examination of archives. To understand the underlying process of strategizing, we need to learn about the concerns and perceptions of foreign investors regarding local circumstance (formal and informal institutions) and how firms respond to these circumstances. In China, in particular, foreign investors usually encounter and negotiate the institutional environment at the sub-national level, the understanding of which cannot be restricted to generalizations about laws and regulations, but very often must include informal institutions as well. For example, as a result of fiscal decentralization (Qian and Weingast, 1997), local governments are very concerned with the economic performance of their jurisdictions, and thus compete with one another for resources. FDI not only provides capital inputs, but has high potential spillover effects for the local economy. Therefore, local governments have strong incentives to compete with one another for FDI which has become a “window” on their political and economic performance. Local governments, as agents of the central government, implement central policies, but may circumvent these policies if they perceive it to be in their interest to do so; for example, in order to attract foreign investment (Peng, 2000). The knowledge regarding these local and informal institutions can best be collected through direct observation and conversation (Krug,

2004). Interviews prove to be a valid instrument to investigate motives, constraints and process-oriented knowledge (Bewley, 2002; Büchel, 2002). Given the Chinese economy's complexity and dynamism, interviews are among the most useful instruments to learn about influencing variables and the causality among variables of the phenomenon (Roy et al., 2001; Tsui et al., 2004).

We conducted semi-structured face-to-face interviews during the on-site visits to every firm during the periods from September to November 2004 and from July to August 2005, and in December 2006. All interviewees except those in three cases belong to the top management team of their firms and have been working there since the formation, and thus they are knowledgeable enough about the events surrounding the ownership mode choices and their political behaviour in managing the relationship with local governments. Each interview lasted one to two hours. One or two interviewees per firm participated in the interview. Two or more interviewers conducted all interviews, recorded notes for each interview with permission, and transcribed these notes into a single report per firm later in the same day. The answers were often repeated and discussed on the spot. The validity of the interview data was thus assured by timely transcription and member check.

To assure the validity of our analysis, we additionally conducted face-to-face interviews at four MNCs' regional headquarters in China. These four MNCs operate in the electronics, chemical, beverage, and financial services sectors respectively. The informants from the first three MNCs were (ex-) general managers of their China headquarters, and the informant from the last MNC was a vice-president. They confirmed information regarding the ownership mode choices of their subsidiaries in China and their political activities. Furthermore, we interviewed six government officials in the development zones in order to get "the other side of the story" (Peng, 2000). The officials we interviewed included three holding the position of deputy director on the development zone administrative committees of Suzhou, Hangzhou and Dezhou, and another three holding the position of deputy director in the taxation bureaus of Suzhou. Finally, we collected archival data for each firm from various sources such as company websites, corporate brochures, newspapers and magazine reports. These data provided a backup or blind check to the interview data.

1.4 A Reader's Guide

This dissertation proceeds by providing a thorough description of the behaviour of foreign firms entering and operating in China in *Chapter 2*. This description shows

the uniqueness and success of China as a destination for FDI. It further explains the success of foreign firms by looking into their location choices within China, their ownership choices in response to institutional changes, and their local embeddedness in governance. This description provides a general picture and ecology of foreign firms in China's economic transition.

The main part of this dissertation is formed by three empirical chapters. In *Chapter 3*, dynamics of homogeneity in foreign ownership is analyzed on the basis of population. This analysis relies on panel data from foreign firms during the period 1979 to 2003. Chapter 4 and Chapter 5 rely on case data, the methodology of which is described above. In *Chapter 4*, the ownership choices of foreign firms are analyzed at a firm level, relying on twenty illustrative cases. This chapter in particular looks into the learning process in which foreign firms adapt their ownership preference to *local* circumstance within China. In *Chapter 5*, the analysis is focused on the political strategies of foreign firms in China. This chapter relies on twenty-two cases to explore why and how foreign firms engage in collaborations with *local* governments in China.

Chapter 6 then summarizes the main findings in three empirical chapters. It reflects on using an institution-based perspective to understand the strategies of foreign firms in China and its contribution to the extant body of knowledge. At the end, it points to further avenues for future international business strategy research.

Overall, the three empirical chapters develop a deeper understanding of the behaviour of foreign firms in China. They echo the concerns of scholars regarding the role of institutions in strategizing of foreign firms in host countries not only, but raise concerns about institutions at the local level in China as well. A *local* perspective is thus emphasized when foreign firms strategize their choices and operations within China.

2 Foreign Firms in China: Success by Strategic Choices

2.1 Introduction

Ever since the economic reform started in 1978, China has attracted the attention of Western academics and the business world (e.g. OECD, 2005; Prasad, 2004; Shenkar, 2006). With average annual growth rates of real GDP 9.4 per cent between 1979 and 2004 this cannot come as a surprise. Rather unexpected, however, was the fact that China outperformed the European transition economies. One reason given for this development is the contribution by foreign direct investment (FDI), more precisely the establishment of subsidiaries (i.e. foreign firms hereafter) in China (e.g. EIU, 2003; Lardy, 1995). China was not only the largest FDI recipient among developing countries in 2004, it attracted FDI inflows of 60.63 billion US dollar surpassed only by the United States and the UK.

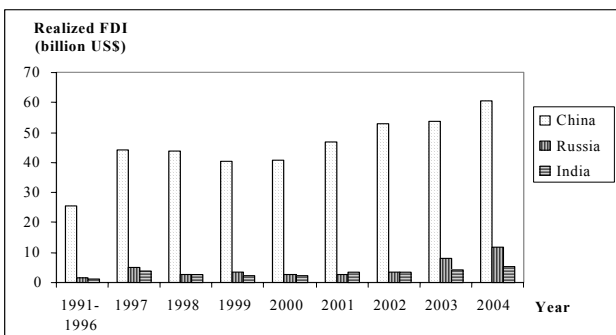
This development raises some questions. First, to which extent does China's overall development depend on past and ongoing FDI? Second, what actually explains the trend? In what follows, an attempt is made to analyse the processes and activities of foreign firms investing and producing in China. After all, without regarding China as an attractive location for investment and production, the observed FDI inflow would not have occurred. If enough foreign firms succeeded in China to induce more firms and/or more capital to follow then we assume that one or more of the following factors must have played a role. 1. *A selection effect*: By carefully choosing the best suited entry strategy only firms with a high probability to succeed invested in China. 2. *An integration effect*: By acknowledging the specificity of the local business environment and developing complementary capacities the foreign firms can exploit the business opportunities offered in China. It is worth mentioning that once production has started and increasingly more since the middle of the 1990s firms are confronted with locally rather than nationally designed constraints and opportunities (e.g. Clissord, 2004; Segal and Thun, 2001). 3. *A learning effect*: By flexibly reacting to an unfamiliar business environment characterised by frequent and sometimes drastic changes firms need to employ

structures and routines that allow for smooth adaptation to new chances and constraints. These three factors are not independent from each other. In what follows they will however be treated separately for analytical reasons.

The chapter is organized as follows: after a general overview of the FDI landscape since 1978 (Section 2.2), our analysis describes the factors which lead firms to invest in China (Section 2.3); identifies factors that inform firms of their entry choices (Section 2.4); and examines the ideas of local embeddedness and adaptation (Section 2.5). This analysis is offered in the context of a generally dynamic situation (Section 2.6).

2.2 Overview

The economic reform and open door policy in 1978 parted the Bamboo Curtain between China and the Western world. At the beginning (realized) FDI increased gradually yet remained small. Nevertheless, by 1990 annual realized FDI was about four times that in 1983. This picture changed dramatically again in 1990s. In 1992 alone, realized FDI amounted to eleven billion US dollar, almost three times the amount of 1991. In 2004, it reached more than 60 billion US dollar, which is almost five times the amount of 1992 and 17 times that of 1990. To put these figures in perspective it is worthwhile having a look at the cases of Russia (another transition economy) and India (another large economy at a similar level of income).



Source: United Nations Conference on Trade and Development, 2003, 2005¹

Figure 2.1 FDI inflows: China, Russia and India

As figure 2.1 shows, FDI inflows in all three economies increased during the 1990s yet those in Russia and India remained far behind China. In 2004 for example China received about nine per cent of the world total FDI inflows, as compared to Russia's 1.8 per cent and India's 0.82 per cent.

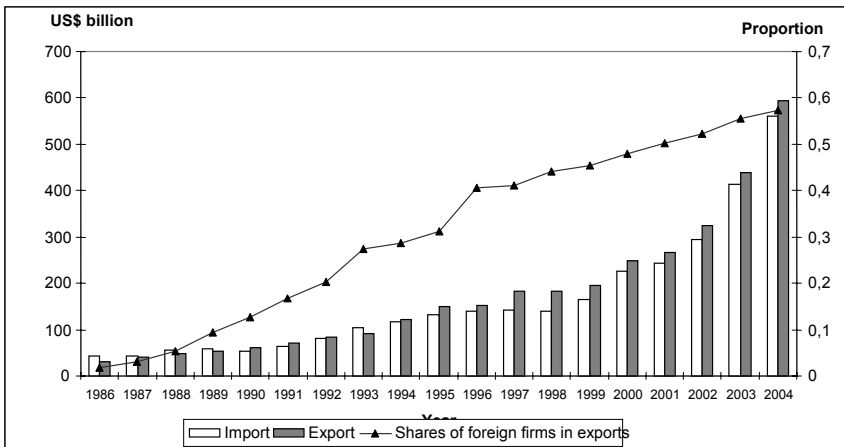
FDI means more than the transfer of capital and technology. It changes the ecology of the Chinese economy when more and more foreign firms operate in China (see column 2 in table 2.1), after decades in which China had remained outside the international division of labour. By the end of 2004 more than 242,000 foreign firms operated in China. However, it should be noted that more than 90 per cent of these entered the market after 1990. The contribution of these firms became considerable. They became a major source for tax revenue (see table 2.1, column 3). In 2004 for example foreign firms generated more than one-fifth of the total tax revenue indicating their crucial role in the economy and the state's finances.

Table 2.1 The performance of FDI in China: 1980-2004

Year	FDI realized amount (billion US\$)	No. of foreign firms in operation	Share of tax revenue (percent) p.a.
1980	-	7	-
1982	1.8 ²	330	-
1985	2.0	4912	-
1990	3.5	25389	-
1991	4.4	37215	-
1992	11.0	84371	4.25
1993	27.5	167507	5.71
1994	33.8	206096	8.51
1995	37.5	233564	10.96
1996	41.7	240447	11.87
1997	45.3	235681	13.16
1998	45.5	227807	14.38
1999	40.3	212436	15.99
2000	40.7	203208	17.50
2001	46.9	202306	19.01
2002	52.7	208056	20.52
2003	53.5	226373	20.90
2004	60.6	242284	20.80

Source: China Ministry of Commerce, 2004, 2005; China National Bureau of Statistics, 2004, 2005; United Nations Conference on Trade and Development, 2005

Moreover, foreign firms are also the driving force behind China's integration into the international market as can be seen in the foreign trade statistics (see figure 2.2). Since the reforms, China's imports and exports have rapidly increased, well above global increases. By the end of 2004, the imports and exports reached 561.38 billion US dollars and 593.36 billion US dollars respectively, with an average annual growth rate of 17.5 per cent and 17.7 per cent respectively since the beginning of the reforms. As a consequence, China's contribution to world exports increased from 1 per cent (in 1980) to more than 6 per cent (in 2004). The export success of China's economy is to a great extent the export success of foreign firms in China (figure 2.2). While in 1986, foreign firms' share of total exports was only 1.9 per cent, in 2004 this share had increased to 57.1 per cent.



Source: China Ministry of Commerce, 2004, 2005; Liang, 2004

Figure 2.2 Imports and exports of China 1986-2004

Even more striking is the extent to which the composition of exports changed. China's exports have shifted from natural resource-based products (e.g. grain and oil) to labour-intensive products (e.g. garment and textile products), and lately to technology-intensive products (e.g. machinery and computer products). In 2004, machinery and electronic products amounted to 54.5 per cent of the total export values, of which more than 70 per cent were produced by foreign firms (China National Bureau of Statistics, 2005). Another example is the emergence of a Chinese IT sector in the 1990s, which proved to be so internationally competitive that China is one of the top three exporters in the world today (Amighini, 2005). In this case too, foreign firms dominate China's exports: 87.3 per cent of exports of high-tech and

new technological products were produced by foreign firms in 2004 (China Ministry of Commerce, 2005).

All in all, the picture summarised above demonstrates the remarkable performance of FDI and foreign firms in China at the macro level, and invites a more detailed analysis of the underlying processes. The first question is why foreign firms would go to China?

2.3 Why Invest in China?

Economic analysis of foreign trade and foreign direct investment in China often cites determinants such as market size, economic development, labour market conditions and infrastructure (e.g. Cheng and Kwan, 2000; Wei, 1995; Wei and Liu, 2001; Zhao, 2003). Market size (measured by GDP or GDP per capita) in combination with economic growth translates into business opportunities for foreign investors. Likewise a huge labour force in combination with low (labour) costs plus a small but remarkably well trained technical personnel add to the attractiveness of China as a factor market (e.g. ATKearney, 2004; Lu and Liu, 2004). China's infrastructure (especially in transportation and communications) is also beginning to contribute to its attractiveness as a location for FDI (China National Bureau of Statistics, 2005).

Another group of studies stress institutional factors, i.e. institutional incentives for FDI. The reforms were accompanied by liberalization in the foreign trade sectors such as the establishment of Special Economic Zones, special tariffs and tax rates. These were designed to attract FDI (e.g. Fu, 2000; Ng and Tuan, 2002; OECD, 2000; Wei and Liu, 2001) by keeping the operating costs within China low (e.g. Kim and Lau, 1994; Krug, 2004; Krugman, 1994). Corruption and regulatory burden though ubiquitous have so far only started to deter investors from North America and Europe (e.g. Khan, 2001). Investors closer to China or her culture do not seem to be worried (e.g. Wei and Liu, 2001), as exemplified by the fact that Asian investors from Hong Kong, Taiwan, Macao, Singapore, South Korea and Japan, still dominate FDI inflow in China (e.g. Chen and Chen, 1998; Lu and Zhu, 1995; Li et al., 2001; Wei, 1995; Yang, 1997; Zhang, 2000, 2005).

All in all, these studies suggest that both economic advantages and institutional incentives attract FDI to China. However, studies at the macro level dismiss two crucial aspects. First, China cannot be modelled as a unified economy, let alone one integrated market. Thus foreign firms need to respond to local rather than national boundaries of markets and institutions (e.g. Demurger, 2001; Dollar et al., 2003).

Second, the success of FDI in China depends crucially on the strategic decisions of foreign firms: what and where they produce, in particular; how they manage their business relationships; and how they deal with local jurisdictions.

Thus it is assumed in what follows that a firm-level analysis is needed to identify (systematic) factors by which the performance of the FDI sector can be explained in relation to its specificity. Studies in international business and strategy addressing this issue point to the importance of choosing the “right” entry strategy, responding flexibly to the local environment while developing the capacity to adapt to changing circumstances (e.g. Buckley and Casson, 1976; Caves, 1996; Dunning, 1977; Ghemawat, 2003; Peng, 2003). In the following, we discuss entry choices and local embeddedness of foreign firms in China respectively, attempting to sort out the major underlying considerations and their dynamic features in order to understand the behaviour of foreign firms in China.

2.4 Investing by Strategic Entry Choices

2.4.1 Perspectives from International Business and Management

One promising starting point for explaining why China has been chosen by foreign companies or MNCs is Dunning’s widely accepted “eclectic approach” (1977, 1988, 2003). At the core of the eclectic approach lies the question why foreign companies establish subsidiaries instead of exporting their products. *Internalizing production* refers to the decision to invest in subsidiaries and is assumed to depend on two further considerations. The first consideration is *location advantage*, which according to this approach is not limited to different resource endowments or labour costs, but also accounts for transaction costs in cross-border trade, which can be circumvented when production is localized. The second consideration is *ownership advantage* when companies that need to keep control over their firm-specific assets, such as intellectual property rights, brand names, or research and development will forego contracts with Chinese partners but insist on subsidiaries.

In other words, the approach suggests that firms will sooner establish subsidiaries the higher the value they attach to their firms-specific assets; that firms will sooner establish subsidiaries when the locational advantages offered by a host country are higher; and that firms will sooner establish subsidiaries when transaction costs in conventional foreign trade are higher. In the case of China, as described earlier, the decision where to locate needs to take into account the costs and benefits of various locations within the Chinese economy. Therefore, firms will establish subsidiaries in

that part of China which offers the best comparative advantage with respect to location. *Risk diversification* arguments, while not part of the original Dunning model, are useful in this case. They suggest that investors or MNCs benefit from locational diversification when doing so offers scale and scope economies, more flexibility, and learning opportunities (e.g. Hall and Lee, 1999; Rugman, 1979). Thus, it can be assumed that firms will diversify risks by investing in different locations selected according to their respective advantages.

What is, however, not explicitly addressed by the Dunning model is the question of how exactly production in China (or any other place) gets organised. *Entry mode studies* offer further insights by drawing attention to different forms of ownership and collaboration with local partners. These studies show that the three dominant foreign ownership modes, i.e. contractual joint venture (CJV), equity joint venture (EJV) and wholly foreign owned subsidiary (WFOE) can be explained by three considerations: transaction costs, exploitation/exploration capability and institutional constraints.

Transaction cost considerations will cause foreign investors to seek more shares and control when confronted with asset specificity and/or opportunism; and conversely, to seek less when facing uncertainty such as political or economic risks (e.g. Anderson and Gatignon, 1986; Delios and Beamish, 1999; Hennart, 1988; Meyer, 2001). Exploitation/exploration capability considerations will cause foreign investors to opt for an EJV when they expect additional returns from broadening their resources and knowledge base (exploration) via a Chinese partner's distributional networks or local knowledge (e.g. Gomes-Casseres, 1990; Madhok, 1997). On the other hand, firms will insist on a WFOE when they expect higher returns from exploiting their firm-specific resources and capabilities (e.g. Agarwal and Ramaswami, 1992; Delios and Beamish, 1999; Luo, 2001a). Institutional considerations remind firms that often enough the envisaged ownership form depends not only on (Chinese) regulations, but also on perceived political risk (e.g. Contractor, 1990; Gomes-Casseres, 1990; Xu et al., 2004; Yiu and Makino, 2002).

In what follows it is assumed that both streams of literature, the eclectic approach and entry mode studies, together provide a fruitful guideline for investigating the behaviour of foreign firms in China.

2.4.2 Choosing the Right Location in China

We next look for the reasons behind locational choice within China. The statistics shows that foreign firms unevenly spread within the country. As can be seen from Table 2.2, when listed according to province the ten most favoured locations are all

to be found in the Eastern region³. The Eastern region hosted 82.43 per cent of the total foreign firms that had been established by the end of 2004. This has to be seen in contrast to the twelve provinces called the Western region, seven of which are found at the end of the list. The Western region altogether hosted 6.53 per cent of the total foreign firms up to 2004. That leaves the eight provinces that are called the Central region hosting 11.04 per cent of the total foreign firms up to 2004 (China Ministry of Commerce, 2005). This pattern has not changed much since the 1980s (OECD, 2002).

Empirical studies analyzing the reasons for patterns of locational choice in China point to factors such as openness for trade, different economic growth rates, manpower, infrastructure and preferential investment policies at the sub-national level (e.g. Broadman and Sun, 1997; Chadee et al., 2003; Gao, 2005; Wei et al., 1999; Zhou et al., 2002). However, these patterns also reflect the investment climate, which is often generated locally (e.g. Dollar et al., 2003; Demurger, 2001; Li et al., 2000).

Thus, for example, many consulting reports and empirical studies attribute the high concentration of FDI in the *Eastern region*, i.e. the *Pearl Delta and Yangtze areas*, to the general investment climate, based on higher GDP per capita, higher concentrations of modern small and medium enterprises, higher educational levels, advanced transportation infrastructure, good shipping connections, and proximity to major international ports such as Shanghai and Hong Kong (e.g. Chadee et al., 2003; KPMG, 2003, 2005; PricewaterhouseCoopers, 2004; Wei et al., 1999).

A closer look, however, points to another determinant, namely the institutional advantage offered by *special economic zones* (SEZs), “open” coastal cities and development zones. Since the early eighties, China has opened certain jurisdictions to foreign investors (such as SEZs, open coastal cities and open coastal regions), mostly found in the Eastern region. These jurisdictions are often endowed with better infrastructure, less state intervention and better developed legal systems. Empirical studies confirm that foreign firms positively respond to these institutional advantages by deliberately locating their investment in these locations (e.g. Li and Park, 2006; Ng and Tuan, 2002; Zhou et al., 2002).

In a second step, sub-national administrative levels were allowed to establish their own *development zones*. This did not lead to a wider geographical spread however, instead the new development zones closely followed the locational choices of FDI (see Table 2.2).

Table 2.2 Geographic distribution of foreign firms by province (up to 2004)

Rank	Province (Region)	Proportion of foreign firms in total	Number of development zones ⁴
1	Guangdong (E)	21.95%	31
2	Jiangsu (E)	12.64%	30
3	Shandong (E)	9.29%	29
4	Shanghai (E)	7.14%	22
5	Fujian (E)	7.04%	17
6	Zhejiang (E)	6.35%	22
7	Liaoning (E)	5.84%	15
8	Beijing (E)	4.27%	5
9	Tianjin (E)	3.37%	6
10	Hebei (E)	2.32%	10
11	Hubei (C)	1.98%	10
12	Hainan (E)	1.89%	4
13	Guangxi (W)	1.62%	7
14	Jiangxi (C)	1.54%	6
15	Hunan (C)	1.50%	5
16	Henan (C)	1.50%	5
17	Jilin (C)	1.43%	9
18	Heilongjiang (C)	1.41%	5
19	Sichuan (W)	1.34%	15
20	Anhui (C)	1.21%	8
21	Shaanxi (W)	0.81%	6
22	Chongqing (W)	0.72%	4
23	Yunnan (W)	0.51%	6
24	Shanxi (C)	0.48%	5
25	Inner Mongolia (W)	0.39%	4
26	Guizhou (W)	0.33%	9
27	Gansu (W)	0.32%	4
28	Xinjiang (W)	0.25%	5
29	Ningxia (W)	0.14%	1
30	Qinghai (W)	0.08%	1
31	Xizang (W)	0.02%	1

Notes: E in the bracket indicates that the province is found in the Eastern region; C in the bracket indicates that the province is found in the central region; and W in the bracket indicates that the province is found in the Western region in China.

Source: China Ministry of Commerce, 2005; China Association of Development Zones, 2005.

Within these jurisdictions, industrial sites are parcelled out, roads and public utilities are provided. Most crucial however is the fact that foreign firms in the special zones enjoy tax privileges. Thus, for example, (manufacturing) firms pay only half of the usual rate of 30 per cent; but only after the first two profit-making years, during which they are tax exempted and after another three years during which they pay only 50 per cent of the preferential rate (15 instead of 30 per cent). Technologically advanced firms and export-oriented firms can expect even further tax reductions after these five years. Harder to assess is the effect of regulation and state intervention in these zones. As empirical studies have shown, the zones have enough leeway to design their own “industrial policy”, often enough in consultation with the foreign companies already operating in the zone. As a consequence the special zones together offer a comparative advantage when compared with the “rest of the country”. As different special zones offer different sets of rules and regulations foreign firms will decide on location not only according to (short term) cost advantages, or infrastructure, but also according to the best “fitting” regulatory regime.

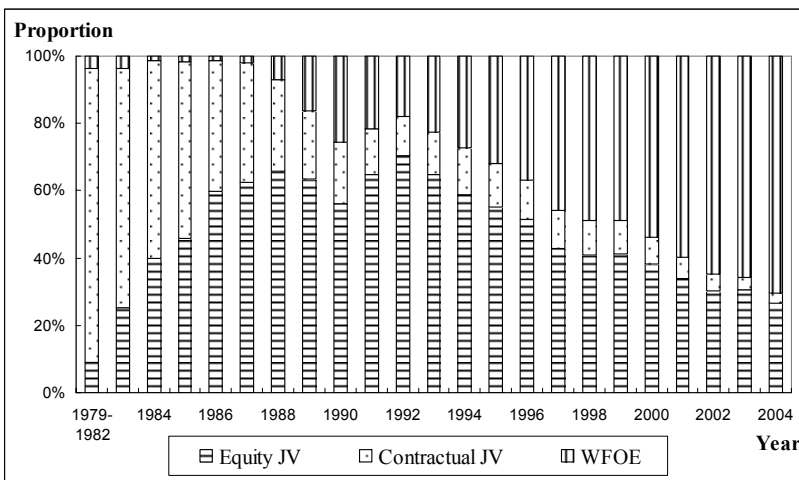
To sum up, investment patterns point to the influence institutional factors have on the investment decision of foreign firms, which diversify their total investment across different localities. That this is a response to regulatory arbitrage is one reason. Another reason is that by doing so “confiscation risk” and the risks associated with weak contractual enforcement (e.g. Clissord, 2004; OECD, 2005; Stuttard, 2000) can be reduced. These considerations explain the following feature of foreign investment in China: An overview of the global 500 MNCs shows that most of those who are present in China have invested in two or more locations, with Mitsubishi as the extreme having established 131 subsidiaries in 31 locations (Wang, 2004). A detailed case study of Coca-Cola (Mok et al., 2002) finds that Coca-Cola, facing regulation and contractual risks in different locations, had set up bottling plants in 21 locations to diversify the risk and exploit the regulatory arbitrage.

2.4.3 Ownership Choice

So far it has been shown that firms reduce their investment risk or improve their expected returns by carefully selecting location or spreading total investment across different locations. The next question is to which extent firms attempt to mitigate risk or ensure best use of their capabilities by choosing an appropriate ownership mode.

That there has been a striking change in the relationship between foreign firms and domestic economic actors is underlined by the fact that by 1982, 86 per cent of

foreign investors had set up a contractual arrangement or contractual joint venture (CJV) with Chinese companies, yet this dropped to only 3 per cent by 2004 (see figure 2.3). Since then most foreign firms opt for equity joint ventures (EJV), or wholly foreign owned enterprises (WFOE). The percentage of EJVs in the total foreign firms reached its peak (72.5 per cent) in 1992 and dropped to 26.5 per cent in 2004. While up to 1982 only 3.6 per cent of foreign investors established WFOEs, the percentage jumped to 70 per cent in 2004, when a change in law (1986) allowed the establishment of completely foreign affiliates. The question is therefore, why do foreign companies prefer to establish subsidiaries instead of opting for joint ventures with Chinese partners who could be expected to provide valuable (market) information and business related knowledge.



Source: China Ministry of Commerce, 2004, 2005.

Figure 2.3 Ownership choices of foreign firms in China by year

On a more general level, what considerations determine the ownership choices of foreign firms in China? Once more, *transaction cost, capabilities and institutional considerations* play a role. Empirical studies reveal that both asset specificity (plus risk), firm-specific capabilities and government regulations have been crucial for foreign firms to choosing between contractual arrangement and EJV (e.g. Pan and Tse, 2000; Tse et al., 1997) as well as between EJV and WFOE (e.g. Guillén, 2003; Luo, 2001a; Pan, 1996). When firms possess specific assets such as R&D, proprietary product information and marketing expertise, an EJV is preferred to

contractual arrangement, and a WFOE to an EJV. When foreign investors seek local knowledge or capabilities (such as distribution networks and local technologies), they prefer EJV over WFOE. Once again, government regulations interfere with economic considerations. Not only does the perceived risk and opportunism of domestic partners matter, but also the degree of liberalization for choosing the best organizational form.

The further question is whether all three considerations determine the decision equally. An analysis of the *dynamics of interaction* with government regulation and agencies provides further insights. Empirical studies point out that ownership choices are based on rational calculations, institutional constraints in a host country, and its localities. Under strict, but weakly enforced government regulations, foreign firms are less able to implement their rational choices but need to compromise instead (e.g. Contractor, 1990; Gomes-Casseres, 1990). Thus, for example, in the early 1980s, foreign firms continued to opt for CJVs although the EJV Law had already been promulgated in 1979. The ambiguity of the new law made contractual arrangements more attractive as these offered more flexibility in changing the terms of the business relation with the Chinese partner. The amendments to the EJV Law in 1983 which clarified specific rules and signalled the seriousness of the policy changed the picture: an increasing number of foreign firms opted for EJVs, as this organisational form offered more effective ways to protect their China investment and promised a higher co-operation rent. After the WFOE Law was promulgated in 1986, the institutional environment changed again allowing investment that left firms “exclusively” in the hands of foreigner. The shift to WFOE promised better control over the operation of a company and its assets to foreign investors, in particular patents and product-specific know-how. For example, Johnson & Johnson, although running some successful pharmaceutical EJVs, shifted to WFOEs in 1992 claiming better monitoring capabilities and less government restrictions (Vanhonacker, 1997). Gradual movement in response to institutional changes reveals that foreign firms’ ownership choices are responsive to the institutional situation, selecting that alternative which promises the best protection of their investment and more freedom for their operational strategies.

In addition, the decentralised structure of the Chinese economy and the differences between economic zones allowed some foreign firms to be proactive in their choice. Thus, a total of 120 WFOEs had been established in several locations before the WFOE Law was enforced in 1986 (Fu, 2000). The reason given was that only by granting investors the right to establish a WFOE would they introduce their advanced technologies; as was the case with 3M in Shanghai, for example (Brown, 1986).

As the example shows, the *protection of property rights*, especially of intellectual property rights, remains one of the major concerns of foreign investors (Pearson, 1991; Roehrig, 1994). The Chinese government's response was the promulgation of a set of laws, such as the Trademark Law, Patent Law, Contract Law and Copyright Law. In addition, China has subscribed to the Berne Convention for the Protection of Literary and Artistic Works and the Universal Copyright Convention. Nevertheless the general feature of weak protection of property rights and weak enforcement of contracts cannot be argued away (e.g. Krug, 2004; Michael and Rivette, 2004). This explains why foreign firms prefer WFOEs, though they forego the comparative advantage of having a Chinese partner in particular in industries where intellectual property rights are at stake (Michael and Rivette, 2004).

On the other hand, foreign firms prefer EJVs when they use standardised technology, and when they depend on local complementary resources including local networks. One such an example is Phillips' EJV with Neusoft, one of China's leading software companies, to jointly develop medical information systems. Another example is 3COM's EJV with Huawei to utilize Huawei's advantages in data communications.

All in all, foreign firms are involved in an interactive process where they respond to changes in Chinese law, while trying to negotiate further changes. It is this interaction which once more points to the significance of locational choice. On one side "endowments" such as good infrastructure, a cheap labour force or a transparent regulatory regime are linked to different locations, thus offering incentives for foreign firms to search for the best fitting place. On the other hand, as was shown above, these features are not stable but change over time due to market development and policy change. Moreover, foreign firms do not need to remain "institution takers" (to use the analogy with "price taking" firms). Instead they can actively search for ways to directly (via negotiation) or indirectly (via "exit" and investment of new firms in other locations) influence further institutional change. As will be seen in what follows this situation is not China-unique but reflects strategic choice by foreign firms.

2.5 Foreign Investment and Local Embeddedness

The institutional business context of firms has long been recognized as crucial to firm's performance (Galbraith, 1973) and gained new prominence with globalisation and the emergence of transition economies (Child and Tse, 2001; Henisz, 2000; Peng, 2003). Thus, it is argued that the more "foreign" a potential host country the

more important it is for a foreign firm to gain legitimacy (e.g. Kostova and Zaheer, 1999; Xu and Shenkar, 2002) particularly in China's case (Khanna et al., 2005). One way to do so is to closely cooperate with local business communities and local governments, by jointly searching for an organizational 'fit' with the overall, i.e. national institutional environment. The 'fitting' strategy helps foreign firms to gain access to and better understand local business routines and government regulations. By doing so, foreign firms build up resources and abilities to better cope with institutional idiosyncrasies, which in turn increases the value of their business relations in China (Frynas et al., 2006; Henisz, 2003).

In short, *local embeddedness* (Granovetter, 1985) becomes a business strategy which offers high returns in particular in a country such as China where the business context differs widely across the country. In what follows we describe the specific feature of the heterogeneous business context and provide evidence that foreign firms do indeed take the advantage of local embeddedness into account when they invest and when they operate in China.

2.5.1 Local Governments and Transaction Costs

To understand the local embeddedness feature of foreign firms in China, it is important to understand the decentralized character of the Chinese government which facilitated the emergence of different business environments.

Previous studies, especially in international business and management, do not acknowledge the wide ranging effects of the reforms in the 1980s which led to decentralization. Decentralization in China does not refer to the legislative or regulatory power of provinces. Instead it refers to shifting resources (such as land) and regulatory power to the local (i.e. sub-provincial) administrative level (e.g. EIU, 2003; Lau et al., 2000; Nee, 1992; Qian and Weingast, 1997; Walder, 1995). While, on the one hand, local governments are expected to implement and/or interpret central policy, on the other hand, they enjoy considerable leeway to design their own policies. The local sources of income whether alimented by tax revenues, profit from still not yet fully privatised companies, or land deals, severely limits the central government's ability to control the localities via a budget constraint. In short, the Chinese economy is characterised by a weak central state, with local government agencies as the primary economic actor for economic development. This form of local autonomy explains why foreign firms have a variety of commercial experiences depending on the locality they operate in, or more precisely, the local government they are confronted with. *Local governments are the key actors, the*

main institutions foreign firms have to reckon with when they intend to build up local knowledge.

Lacking local knowledge or local protection generates transaction costs for firms (e.g. Wei, 1996; Zhao and Zhu, 2000, Clissord, 2004). The transaction costs refer to those institutional obstacles to doing business in China, such as economic and policy uncertainty, arbitrary interpretation of policies, weak enforcement of regulations and corruption etc, as the enterprise survey of World Bank shows (see table 2.3).

Table 2.3 Perception of foreign firms on obstacles to do business in China (percentage of firms indicating indicator as an obstacle to business)

Indicator	China	Russia	Indonesia	Philippines
Economic and regulatory policy uncertainty (%)	31.54	32.85	48.25	28.35
Macroeconomic instability (%)	28.06	28.74	50.07	39.66
Business licensing and permits (%)	18.81	14.53	20.48	12.45
Consistency of officials' interpretations of regulations	68.43	25.18	44.04	49.90
Senior management time spent dealing with requirements of regulations (%)	20.24	10.04	5.47	8.24
Unofficial payments for firms to get things done (% of sales)	1.99	1.50	1.76	1.73
Gifts requested by government officials	100.00	..	5.61	0.00
Time firms spent in meetings with tax officials (days)	14.55	..	1.97	3.75
Firms expected to give gifts in meetings with tax inspectors (%)	45.93	53.62	11.22	28.15
Value of gift expected to secure government contract (% of contract)	2.31	1.62	0.75	1.92
Confidence in the judiciary system (%)	82.87	34.89	59.19	64.80

Source: World Bank, 2005.

Yet, these transaction costs can be lowered by actively searching for ways which turn local governments into co-operating economic actors (Krug and Hendrichske, 2005; Segal and Thun, 2001). As the example of the TVEs and other private companies in China shows, a formal or informal co-operation with local government agencies offers an effective way for not only lowering transaction costs, but also for getting access to more business opportunities (Che and Qian, 1998; Li, 1996; Wong et al., 2004).

2.5.2 Alliances and Networks as Governance

As discussed above, it is assumed that foreign firms will invest into relation building at the local level in China. Indeed, empirical studies on foreign firms' success in China emphasize cooperation with local institutions and the ability to manage cultural distance or understand local knowledge, while pointing also to traditional firm-specific advantages such as quality input of technology, management skills, control rights over operation, and support from parent corporations (e.g. Child and Yan, 2003; Isobe et al., 2000; Luo, 2002c; Luo and Park, 2004; Peng and Luo, 2000; Shenkar, 1990; Yan and Gray, 2001). Such cooperation with local institutions allows the firm to be embedded into the local institutional environment.

Cooperation provides advantages such as reducing the complexity of the institutional environment, characterized by ambiguous property rights, incomplete transmission of information, uncertainty, inconsistent government policies (e.g. Boisot and Child, 1999; Krug and Pólos, 2004; Shenkar, 1990). At the local level additional factors, such as regulatory and policy inconsistency (in interpretation), corruption, bureaucratic inefficiency, capital controls, local protectionist policies (entry and exit barriers), and cultural adaptation (Hallward-Driemeier, 2003; International Finance Corporation, 2005), add to the amount of problems firms need to learn to cope with. *Investing in good relations with local governments is as necessary a strategy as investing in business networking* for reducing transaction costs and acquiring market (and political) information in China (e.g. Lau et al., 2000; Luo, 1997; Peng, 2003; Qian, 2002).

First, foreign firms deliberately embark on an *alliance or coalition with local governments* to safeguard their operation. Local governments in China are actively involved in shaping the local institutional environment and the business activities that take place in this environment (Nee, 1992; Oi, 1995; Walder, 1995). In the interaction with foreign firms, local governments play a double role. On the one hand, local governments collaborate with foreign firms in bargaining with the central government to change regulations (locational competition effects); and on the other hand, local governments implement and reinforce national and local policies and regulations that affect foreign firms. Therefore, cooperation (or alliance) with local governments becomes the best choice, providing foreign firms with both the political leverage and strategic resources to their operation (e.g. Krug and Hendrichske, 2005; Peng, 2000; Yeung, 2000). In an information poor environment like China, it provides advantages in both information costs and transaction costs. Peng (2000a) notes that Beijing Jeep, Shanghai Volkswagen and Guangzhou

Peugeot all benefited from the coalition with local authorities which helped them to bargain with the central government to get preferential treatments.

In practice, secondly, foreign investors do not have to directly interact with local authorities, but can *rely on partners* who have knowledge of local culture, language and institutions (e.g. Henisz, 2000). A cross-sectional analysis demonstrates the significance of choosing the right local business partners (Luo, 1997). The right local partners can help foreign firms to boost market expansion, obtain insightful information, mitigate operational risks and obtain context-specific knowledge. In this sense, overseas Chinese enjoy an advantage over western investors, who know better and learn quicker about the local context or doing business in China. In addition, overseas Chinese have also an advantage over local agents who lack international experience. Therefore, besides local partners, Hong Kong firms are often sought by western investors for partnerships (e.g. Pan and Tse, 1996). These studies show that such cooperation provides leverage in an uncertain environment and hence has a positive effect on firm performance.

Developing a formal business alliance certainly is not the whole story. In the context of China, business is often done through *interpersonal networks (guanxi in Chinese)*⁵. *Guanxi* networks are regarded as an information and resource pool (Park and Luo, 2001; Tsang, 1998). In an environment where formal economic institutions are ill-functioning, *guanxi* networks, as informal institutions, are often decisive for foreign investors in capturing local knowledge, enforcing business deals and increasing the efficiency of private exchanges (e.g. Krug and Hendrischke, 2005). Local partners (or personnel), including overseas Chinese partners, often act as agents of foreign investors to access local *guanxi* networks which are cultivated through a trust-building process (e.g. Yang, 1994). This aspect of *guanxi* building demonstrates that successful foreign firms are often locally embedded while capturing social capital. One revealing fact is that foreign firms gradually tend to hire local managers to replace expatriates in management. Partly this is due to low costs and improved quality of local managers, but more importantly, it is due to the advantage of local managers in local knowledge and local (business) networks (e.g. Kamis, 1996). Yeung and Li (2000) confirm that, in Shanghai, the managerial structure has been highly localized, as most of the foreign firms have locally nominated chairmen and vice-general managers and more than half of the managerial staffs are local. Even in the more conservative Japanese subsidiaries a high degree of control has been ceded to local managers (Taylor, 1999).

To conclude, foreign firms in China adopt both formal alliances and informal *guanxi* networks (e.g. Peng and Luo, 2000). These interrelated mechanisms facilitate foreign firms to obtain access to local authorities, gain tacit information on policies,

explain their policy concerns and negotiate on regulations, mitigate official arbitration, and avoid government intervention (e.g. Child, 1994; Luo and Park, 2001; Peng and Luo, 2000; Shenkar, 1990). In other words, local embeddedness helps a firm to get an understanding of, and subsequently leverage of, the local institutional environment in order to mitigate transaction costs.

2.6 Conclusion

The chapter describes the strategic choices of foreign firms on entry and in operation, by which to provide an interpretation of the success of foreign firms and FDI performance in China. The description reveals that institutional factors play a significant role in the choices of foreign firms, which require “fit” and adaptability. In a dynamic view, these choices change over time in response to institutional changes (for an overview, see appendix).

First, location choices reflect institutional differences across the country. Foreign MNCs deliberately choose coastal regions to establish subsidiaries, where the overall investment climate is better than other regions. It is highly consistent with theoretical prediction and other similar observations of international investment (e.g. Dunning, 1986; Henisz, 2000; OECD, 2002). With the expansion of open regions into the inland area, more foreign firms gradually invest or re-invest in the central or western regions of China to exploit the low-cost production factors (labour, land and resources), but the institutional momentum is not strong enough to alter the geographical imbalances of uneven distribution. In addition, the first-mover institutional advantage of the eastern region can not be played away by overall openness.

Second, ownership choices demonstrate dynamism over time, with preferences changing in response to the process of institutional liberalization. While the contractual arrangement was mostly opted by subsidiaries in the early 1980s, WFOEs have become the preferred option since ownership restrictions were lifted and the protection of property rights has become more assured. In the current landscape, EJV and CJV still exist along with WFOEs. In other words, ownership choice was highly constrained by the regulation, but now mainly reflects foreign MNCs’ consideration regarding capability/market exploitation and exploration.

Third, local embeddedness has always been crucial to the success of an operation, which helps them to deal with the complexity and uncertainty of the local institutional environment in China. Foreign firms learnt to form alliances with local governments and build up *guanxi* networks (through local managers or other

personnel) at the local level. It makes them closely linked to local institutions, the advantage of which is economizing on transaction costs and information costs involved (Wei, 1995; Zhao, 2003). The choice of blending formal alliance with informal *guanxi* networks has been widely acknowledged by foreign firms in China, which provides them with the capability to manage institutional deficits in the context.

As was shown, the behaviour of foreign firms is a response to institutional conditions and changes in China. To better absorb the above findings, it is worthwhile reviewing the process of institutional liberalization and its effects on firms, as shown in the Appendix. The process takes place in both time and spatial dimensions. Over time, the changes liberalize foreign firms' ownership choices in China and access to locations (from SEZs to open coastal cities then to inland cities), reduce tariffs, and provide improving legal supports for contractual issues and protection of (intellectual) property rights. It has been an interactive process through which Chinese governments also learn, by monitoring the behaviour of foreign investors, to improve the legal systems and clarify policy ambiguity (e.g. Pearson, 1991).

By interacting, foreign firms learn to understand the context and develop "fit" strategies for success. This chapter shows that, perhaps the most striking feature of the experience of foreign firms in China is that an entry strategy is much less important than was assumed 20 years ago. Once operation started, whether the entry mode was contract or joint venture, no concern was more pressing than the question of negotiating the local business environment. In this sense, localizing seems to be the most promising strategy. It is worth stressing that unlike 25 years ago, when foreign firms negotiated with representatives of the ministries in Beijing, localization today refers not only to attempts to cope with the "Chineseness" of the environment, but also the attempt at virtually "going local". Firms meet representatives of local governments which also are the major agents for establishing and running SEZs or any other lower-level jurisdiction. To invest in the accumulation of local "knowledge" promises high returns in particular in the cases where local governments invite the business community in the jurisdiction to participate in the operation of the zone. By doing so foreign firms can influence the tax and regulatory framework to the effect that the environment looks more familiar and allows more familiar business practices. The high concentration of foreign firms in specific places points in the same direction: proximity between foreign firms allows knowledge-sharing and joint "lobbying" for favourable local policies.

All in all, the behaviour of foreign firms seems to confirm the following: firms react more strongly to transaction costs generated in the external environment than

to contract-specific transaction costs that characterise their interaction with other foreign or Chinese firms. Localization proves to be the most suitable choice for their success (see chapter 4 and 5).

Notes

1. The amount indicated to 1991-1996 is the average annual FDI inflows in this period.
2. This amount is the sum of the period 1980-1982.
3. Three regions are separated in China. The eastern region includes: Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan. The central region includes Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. The western region includes Guangxi, Inner Mongolia, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang and Xizang.
4. The data are as of September 2005 when the website was searched. The number is counted for development zones at the provincial level and above.
5. Though some studies show that larger firms with greater level of internationalization are more likely to have capabilities to leverage on the uncertain environment (e.g. Gaba et al., 2002), the preponderance of overseas Chinese firms proves that guanxi networks do play a greater role in China in reducing information costs and transaction costs, which facilitate the entry and operation of smaller firms but with higher level of local knowledge (e.g. Gao, 2003; Li et al., 2001; Wang and Ellis, 2002). In addition, the diversity in local cultures implies that guanxi networking is eminent and crucial in business (e.g. Tse et al., 1997).

Appendix

Institutional Changes in the FDI Regime in China¹

Phases	Year	Law	Year	Spatial 'Opening'
1979–1985: Permitting FDI	1979	EJV Law	1980	4 SEZs.
	1980	Income Tax Law of EJVs	1984	14 coastal cities;
	1981	Economic Contract Law		Hainan Island
	1982	Trademark Law; Income Tax Law of Foreign Enterprises	1985	Yangtze River Delta; Pearl River Delta;
	1983	Exchange control for foreign enterprises		'Golden Triangle'
	1984 1985	Patent Law Accounting Law; Imports and Export Duties		
1986–1991: Selective incentives for FDI	1986	WFOE Law; HR liberalisation; Bankruptcy Law;	1988 1990	Liaodong, Shandong . Pudong .
	1987	Tariff reduction		
	1988	CJV Law; Procedural rules for arbitration		
	1989	Administrative Litigation Law		
	1991	Integrated Income Tax Law; Copyright Law		
1992–1996: FDI liberalisation	1994	Arbitration Rules; Consumer Protection Law; Labour Law; Foreign Trade Law	1992	21 cities (including border cities and most provincial capitals)
	1996	Litigation law		
<i>From 1992, special economic zones could be established by local jurisdictions (called 'development zones')</i>				
1997–on: Routinisation of FDI	1999	Individual Wholly Invested Enterprises Law	1997	Inland regions
	2000	Liberalisation of Labour Market		
	2003	Mergers and Acquisitions by foreign investors; Protection of Intellectual Property Rights		

Source: China Ministry of Commerce, 2005; Huang, 2001; Van Den Bulcke et al., 2003:23–24.

1. What open cities or regions and SEZs have in common is a more positive attitude toward domestic and foreign entrepreneurship. The difference is that SEZs' explicit purpose is to attract FDI and firms.

3 Dynamics of Isomorphism: An Empirical Study of Ownership Choice of Foreign Firms in China

3.1 Introduction

This chapter examines organizational changes in a dynamic institutional environment by looking into foreign direct investments (FDI) in China. China's economic reform and open door policy has led to the emergence of new firms. In particular, foreign firms allow involvement of *foreigners* in ownership. Foreign ownership means that foreign firms can choose one from three distinct ownership forms, i.e. a contractual joint venture (CJV), an equity joint venture (EJV) and a wholly foreign owned enterprise (WFOE) (Li et al., 2007; Wang, 2006). Foreign ownership choice converged to CJVs (homogeneity) in 1982. The relative composition of three forms in the population changed over time however. The most important changes include decreasing significance of CJVs, increasing significance of WFOEs, and a reversed "V" shape of the importance of EJVs. As a consequence, the ownership choice made by foreign firms demonstrates more heterogeneity in 2005 than in 1982. This provokes the question as to what determines the shift of ownership choice of foreign firms in China from homogeneity towards heterogeneity.

Ownership choice of foreign firms has been widely investigated in international business studies from a strategic perspective. Theoretical approaches used include transaction cost theory (e.g. Anderson and Gatignon, 1986; Hennart, 1988) and the learning perspective (e.g. Barkema and Vermeulen, 1998; Kogut and Singh, 1988). These approaches emphasize that ownership form is deliberately selected by firms to enhance efficiency and competitiveness. Recently, institutional theory has been introduced to explain the ownership choice of foreign firms in host countries (e.g. Lu, 2002; Yiu and Makino, 2002). This theory posits that ownership choice is a response of foreign firms to isomorphic pressures from the institutional environment in order to gain legitimacy. Previous studies show that contextual factors from

institutional environments play a significant role in ownership choice (Delios and Beamish, 1999; Gomes-Casseres, 1990). We therefore argue that combining strategic and institutional perspectives provides a better understanding of the ownership choice of foreign firms in host countries.

Although some studies have considered both strategic factors and institutional factors (e.g. Delios and Beamish, 1999; Lu, 2002; Luo, 2001a; Yiu and Makino, 2002), they have focused on analyzing entry choice at an individual level, rather than at the population level. These studies have demonstrated the effect of various factors on the ownership choice of an individual foreign firm, but they fall short in explaining the dynamics of ownership choice in a population over time. Nevertheless, we take institutional theory (e.g. DiMaggio and Powell, 1983; Meyer and Rowan, 1977) as a starting point. Institutional factors matter to foreign firms much more in transition economies than in developed economies (e.g. Makino et al., 2004; Vanhonacker, 1997). While institutional constraints represent external forces influencing organizational choices, the strategic perspective provides additional logic of internal managerial discretion. Both strategic and institutional perspectives suggest that dynamics of isomorphism can be expected from organizations that face with institutional changes in the environment. Yet, this kind of dynamic phenomenon has remained under-explored in institutional theory with a few exceptions (e.g. Haveman and Rao, 1997; Kraatz and Zajac, 1996).

We contribute to this research gap in both institutional theory and international business by investigating the longitudinal development of an organizational population – foreign firms in China. The FDI sector in China provides us with a particularly relevant setting where foreign firms choose an ownership form for certain strategic goals but their choices are substantially constrained by institutional pressures that are changing over time (e.g. Li et al., 2007; Vanhonacker, 1997). The unit of analysis is at a population level, examining the homogeneity development of foreign firms in China in response to institutional changes. To do so, we rely on a panel data of foreign firms in China from 1979 through 2003. From an empirical perspective, homogeneity is always a matter of degree. Observing the high degree of homogeneity of foreign firms in the beginning of Reform China, we expect to find that both institutional liberalizations and strategic considerations by foreign firms determine decreasing homogeneity over time. In the study, we assume that both strategic and institutional logics work independently. In the empirical models, we examine effects of institutional factors and strategic factors separately first, and then examine how each set of variables add incremental explanatory power to the dynamics of isomorphism. This study enriches our understanding of institutional theory, deinstitutionalization and ownership choice of the foreign firm population.

The rest of the chapter is structured as follows. Section 3.2 introduces theories and develops hypotheses. Section 3.3 outlines the data collection and analysis methods. This is followed by a description of empirical results (Section 3.4). In Section 3.5, we discuss the results, theoretical and empirical implications and limitations that can be addressed in future research.

3.2 Theory and Hypotheses

3.2.1 Theoretical Background

This study was designed to analyze the dynamics of ownership choice of foreign firms in China by combining institutional theory and the strategy perspective. Ownership forms for entering and investing in China represent different degrees of local acceptance, equity control and opportunities of learning local knowledge. WFOEs have a lower degree of local acceptance than EJV and CJV since they “reject” ownership involvement by local partners (e.g. Pearson, 1991). In contrast, WFOEs provide foreign investors with full equity control. EJV provide only partial control ensured by equity shares of foreign investors (e.g. Gomes-Casseres, 1990; Lu, 2002; Luo, 2001a). In CJV, the control claim must be negotiated (Wang, 2006). In addition, WFOEs offer little learning opportunities regarding local knowledge, while EJV and CJV provide more opportunities for learning in that foreign investors possess substantial cognitive distance with local partners (e.g. Gomes-Casseres, 1990; Harrigan, 1988; Nooteboom, 2004). Therefore, the three ownership forms embody varied institutional pressures and distinct strategic considerations.

The central premise of institutional theory is that organizations adopt forms that are similar to those of other organizations in order to gain legitimacy (Deephouse, 1996; DiMaggio and Powell, 1983). Three kinds of isomorphic pressures have been identified as driving forces to isomorphism and homogeneity, including regulative, normative and cognitive institutions (e.g. Scott, 2001). While regulative and normative institutions refer to external constraints, cognitive institutions refer to internal beliefs of organizations. The underlying assumption of institutional theory is that institutions and therefore institutional pressures remain unchanged. However, Oliver (1992) argues that institutions “may be much more fragile and less evitable than institutional theory suggests”. In addition, entrepreneurs (DiMaggio, 1988; Garud et al., 2002; Dorado, 2005) may seek new ways of organizing instead of conforming to established institutions under the conditions of uncertainty. Therefore,

Powell (1991) argues that changes in organizational pattern often occur “when legal or other rule-maintaining boundaries are relaxed”.

Previous studies are particularly focused on domestic organizations (e.g. Dacin, 1997; Orrú et al., 1991; Singh et al., 1986). Recent studies on cross-border organizations with a particular focus on foreign firms show that foreign investors face a different institutional setting in the host country which gives rise to isomorphic pressures regarding their organizational choice (e.g. Rosenzweig and Singh, 1991; Kostova and Zaheer, 1999; Lu, 2002; Xu and Shenkar, 2002; Yiu and Makino, 2002). Studies on institutional liberalization and deregulation show that, as a result, isomorphic pressures may be released and foreign firms tend to consider the efficiency criterion as more important than legitimacy criterion in their ownership choice over time (e.g. Contractor, 1990; Vanhonacker, 1997). This is particularly the case in China, where legal constraints on foreign ownership have been relaxed (e.g. Fu, 2000; OECD, 2005). When institutional changes occur, organizations often seek new forms to achieve competitiveness, leading to dynamics of organizational pattern (e.g. Kraatz and Zajac, 1996; Haveman and Rao, 1997). Therefore, we expect that the degree of homogeneity of foreign firms in China was high in the early years of the Reform and that it has been decreasing over time as a response to institutional liberalizations.

The strategic perspective, on the other hand, posits that ownership choice is based on an efficiency criterion, which reflects the strategic goals of the organization. Previous studies have highlighted two different strategies, control and learning, determining ownership choice of foreign firms in host countries. A control strategy is generally based upon transaction cost theory (e.g. Gomes-Casseres, 1990; Hennart, 1988). It argues that foreign investors may perceive a high degree of contractual uncertainty in host countries, in which case they prefer to have full control over the operation (WFOE). A learning perspective, on the other hand, suggests that foreign firms prefer to choose joint ventures when they aim at learning local knowledge, but prefer to choose WFOE when they have already mastered local knowledge (e.g. Barkema and Vermeulen, 1998; Hennart, 1991; Kogut and Singh, 1988). It can be argued that at the early stage of entry, foreign firms prefer to establish joint ventures in which they rely on local partners to learn local knowledge; once they have accumulated the necessary local knowledge, their reliance on local partners become less critical and they may go for full control. If more foreign firms choose the same ownership form, we may observe a higher degree of homogeneity among them. Changes of foreign firms in their ownership strategies over time may lead to dynamics of isomorphism as well.

Institutional theory and the strategic perspective thus provide different, but complementary, explanations for ownership choices of foreign firms in host countries. In what follows we develop hypotheses about the effects of institutional changes and strategic considerations on the organizational dynamics of foreign firms in China.

3.2.2 Hypotheses

Institutional Forces

Regulative institutions refer to rules and laws that define what is allowed and what not. Enforcing a relevant law or rule can significantly change the behaviour of entrants and thus the organizational pattern of a population (e.g. Barnett and Carroll, 1993). Liberalization of host government regulations has substantial influence on ownership choice of foreign firms in host countries (e.g. Contractor, 1990). In China, the open door policy has established the FDI sector since 1978. In order to embrace foreign firms, Chinese government enforced the EJV Law in 1979, specifying the scope and conditions of establishing EJVs in China but leaving the specification of WFOE vacant. The Chinese government addressed her preference of joint ventures with the goal of learning advanced technologies from foreign investors (Pearson, 1991). In order to better attract foreign investors, the government enforced the WFOE Law in 1986, which is regarded as an important institutional breakthrough that allowed foreign capitalist firms in socialist China (Fu, 2000; Fang and Tang, 1988). Learning from the past, the Chinese government realized that promoting WFOE would not threaten her sovereignty, especially when the government would still hold the authority to approve WFOE projects. Empirical studies on other countries showed that foreign firms established joint ventures when the regulations were more restrictive, while they tended to choose WFOE when the host government regulations were more liberalized (Delios and Beamish, 1999; Fagre and Wells, 1982; Gomes-Casseres, 1990; Lecraw, 1984; Meyer, 2001; Yiu and Makino, 2002). Therefore, we expect more joint ventures than WFOEs before the WFOE Law was enforced, and since then an increasing adoption of WFOEs. Considering the adaptation inflexibility of established foreign firms (e.g. Haveman and Rao, 1997), we hypothesize that:

Hypothesis 1: With the deregulation of ownership restrictions in China, the homogeneity of foreign firms in entry-mode decisions has decreased.

Normative institutions refer to values and norms that define socially acceptable economic behaviours. Previous studies focusing on domestic organizations often emphasize norms of professionalism and social culture (e.g. D'Aunno et al., 1991; Dacin, 1997; Singh et al., 1986). Entering a different institutional context, organizations must conform to social expectations. Studies focusing on foreign firms (i.e. cross-border organizations) have pinpointed normative forces such as normative distance (Xu et al., 2004), cultural distance (e.g. Kogut and Singh, 1988; Yiu and Makino, 2002) and social acceptance by the host country (Li et al., 2007). While normative distance emphasizes norms of professionalism, cultural distance and social acceptance draw the attention to societal norms of host countries regarding foreign investors. China's acceptance of foreign investors and foreign ownership is arguably related to the progress of economic reforms. In the infant period of the reforms, the Chinese central leadership and the society at large were very cautious of the negative effects of foreign presence and capitalist activities on China. This attitude could be traced back to the Opium War and ideological tensions between socialism and capitalism in the pre-reform era (e.g. Brown, 1986; Pearson, 1991). Therefore, societal norms against capitalism and foreign ownership prevailed. In particular, WFOE had a low degree of acceptance. With the progress of economic reforms, market-conforming values such as competition, risks, profits and private property rights have gradually become more accepted, leading to the entry of private and capitalist firms (e.g. Howe et al., 2003; Liang, 2004). These market-conforming norms have been established within China through media, leading to a higher degree of acceptance of WFOE (Li et al., 2007). Empirical studies have shown that, when normative institutions are more restrictive, foreign investors tend to achieve social acceptance by entering through CJVs or EJVs with socially legitimate local partners (e.g. Kogut and Singh, 1988; Yiu and Makino, 2002). When normative institutions become less restrictive and thus represent more market-conforming values, foreign investors tend to enter through WFOEs (e.g. Li et al., 2007; Vanhonacker, 1997). Therefore, we expect more joint ventures when market-conforming values are weak, but an increasing adoption of WFOEs when these values are well established. Considering the adaptation inflexibility of established foreign firms, we hypothesize that:

Hypothesis 2: The more market-conforming norms are established to accept foreign ownership in China, the lower the homogeneity of foreign firms in entry-mode decisions has become.

Cognitive institutions refer to taken-for-granted beliefs or shared mindsets of organizations in a field. Under the conditions of high uncertainty, organizations seek models set by other organizations in the same field, because prior decisions by other organizations increase the cognitive legitimacy of similar decisions (DiMaggio and Powell, 1983; Greenwood and Hinings, 1996). In this sense, new entrants imitate prior decisions that are regarded as taken-for-granted or appropriate. For example, firms follow leaders in the new market entry decisions (Haveman, 1993) and in adopting multidivisional form (Palmer et al. 1993). Studies in international business also show that foreign firms often decide on their ownership form by imitating other foreign firms that have already been established in host countries (Guillén, 2003; Lu, 2002; Yiu and Makino, 2002). The more a form is adopted, the more likely it is built in the mindsets of new entrants as appropriate. New foreign firms thus tend to imitate the dominant ownership form in China. When the dominant form remains the same over time, we expect a high degree of homogeneity of foreign firms. However, when the dominant form changes over time, we expect a decreasing of the homogeneity of ownership choices in the population. Considering the adaptation inflexibility of established foreign firms, we hypothesize that:

Hypothesis 3: With changing of the collective mindsets regarding appropriate ownership form, the homogeneity of foreign firms in entry-mode decisions has decreased.

Strategic Considerations

A **control** strategy entails that foreign firms capture as high as possible a degree of equity shares. From a transaction cost perspective, ownership choice of foreign firms depends on transaction costs associated with various forms (Gomes-Casseres, 1990; Hennart, 1991; Williamson, 1985). These transaction costs are generated by contractual risks. Empirical studies show that when foreign investors invest product-specific knowledge, they are strongly concerned about hold-up risks by contractual partners (e.g. Child and Yan, 1999; Hennart, 1991; Luo, 2001a). By forming a WFOE, foreign investors keep operations under their own control and avoid hold-up risks by partners. But in an EJV, foreign investors obtain only partial control ensured by equity shares. The opportunism of partners would lead to inefficient operations. In a CJV, the foreign investor relies to a large extent on partners in operation (Wang, 2006). The higher investment value that these partners commit, the more likely it is that foreign investors want to control. We expect that when investment values are low, foreign investors become more likely to choose CJVs or

EJVs; when investment values are high, they become more likely to choose WFOEs. When the average investment value of all foreign firms is small, it is likely that joint ventures dominate in the population. Given the dominance of joint ventures in the beginning of the reform era, we hypothesize that:

Hypothesis 4: The higher the average investment value per foreign firm increases, the lower the homogeneity of foreign firms in entry-mode decisions has become.

In contrast, **learning** refers to acquiring local knowledge and local resources. A learning strategy entails that foreign firms collaborate with local partners. From a learning perspective, ownership choice of foreign firms is in line with their strategies on capability exploitation and exploration (e.g. Madhok, 1997; Teece et al., 1997). Empirical studies show that foreign firms choose WFOE when they possess local knowledge, while they choose joint ventures when seeking local knowledge and resources controlled by local firms (e.g. Agarwal and Ramaswami, 1992; Hennart, 1991; Luo, 2002a). Entering in a new institutional setting, foreign investors need to learn local business routines and institutions. In collaborating with local partners, foreign investors benefit from their complementary capabilities. This learning effect will be greater when the cognitive distance between partners is moderate (e.g. Nooteboom, 2004). In a WFOE, the foreign investor minimizes the cognitive distance by imposing its own routines, but in a CJV, the foreign investor maximizes the cognitive distance by adopting local routines. Therefore, these studies suggest that foreign firms are in favour of CJV when their dominant goal is acquiring local knowledge in China. In the same vein, EJV will be favoured over WFOE in that EJV provides foreign investors with more opportunity of learning local knowledge than WFOE does. Once foreign investors have obtained sufficient local knowledge, they may go for WFOE. Before the open door policy was initiated, foreign firms were virtually absent in China. Therefore, foreign investors had very high demands of learning local knowledge in the early years of the economic reforms. With the development of FDI and foreign firms, the population FDI experience in China will be accumulated over time. New entrants can easily obtain it from other established foreign firms and more and more new entrants will desire to establish WFOE (Li et al., 2007). Therefore, the strategic perspective suggests that a learning strategy and thus joint ventures may dominate in the early stage of reforms in China. Considering the adaptation inflexibility of established foreign firms, we hypothesize that:

Hypothesis 5: *The more population FDI experience of foreign firms is accumulated, the lower the homogeneity of foreign firms in entry-mode decisions has become.*

Complementarity

Institutional theory emphasizes external forces that shape the ownership choice of foreign firms. However, conforming to external regulations may not necessarily be the passive response of firms but can be a deliberate choice by firms (e.g. Oliver, 1988; Pfeffer and Salancik, 1978). In addition, firms always need to achieve efficiency and competitiveness through their organizational and strategic choices (e.g. Barney, 1991; Porter, 1985). The strategic perspective explains internal considerations of the organization in response to external environments. When legal constraints limit the options of firms to pursue their financial goals, managers need to standardize their strategies with options similar to those of their competitors. However, deregulations challenge managers to explore new ways to achieve superior performance and deviate from the established conformity (Pope and Ma, 2005; Rugman and Verbeke, 1998; Tucillo, 1985). Therefore, institutional theory pinpoints a selection process, but the strategic perspective suggests an adaptation process. Scholars propose that organizational choices are interdependent outcomes of both selection and adaptation processes (e.g. Lewin et al., 1999; Haveman and Rao, 1997). We thus argue that the institutional and strategic perspectives are complementary in explaining ownership choices of foreign firms in China. Considering the hypotheses 1 to 5, we propose that:

Hypothesis 6: *Combining institutional factors and strategic factors has higher explanatory power to the decreasing homogeneity in entry-mode decisions than either of them alone.*

3.3 Research Method

3.3.1 Data

To explore the effects of institutional change and strategic objectives on entry-mode decisions by foreign firms, statistical data were collected in China over the period 1979 – 2003. China was selected as the context of this study, because China provides a dynamic environment where institutional complexity and uncertainty

constrain ownership selection by foreign firms. On the one hand, China has been very successful in attracting FDI. It was one of the largest recipients of FDI in 2004, only surpassed by the US and the UK (UNCTAD, 2005). On the other hand, the establishment of foreign firms in China is subject to high constraints on ownership (Fu, 2000; Luo, 2002b; Pearson, 1991). In the early years of the open-door policy, Chinese government accepted FDI as “experiments” only in purposefully established Special Economic Zones (SEZs) in order to manipulate the possible impact of foreign ownership on China’s economy and society at large. Due to the bitter history in the Opium War and the ideological tensions with the West, Chinese government explicitly preferred of joint ventures in order to learn technologies from the West and prevent foreign dominance. Economic transition and deregulation have significantly reshaped the regulatory framework regarding foreign ownership, leading to acceptance of WFOEs. Nevertheless, ownership restrictions still exist in certain sectors such as pharmaceuticals, insurance and telecommunications, as revealed in the *Catalogue Guiding Foreign Investment Industries (1995)*. Therefore, conforming to legitimate entry-forms is of critical importance, and changes in institutional constraints and strategic considerations are expected to determine the dynamics of homogeneity in ownership decisions.

The main sources of data were the annual editions of *Yearbook of China’s Foreign Economic Relations and Trade (1984-2004)* and *China’s Commerce Yearbook (1984-2004)*. The data were cross-checked against *Annual Statistical Bulletin of China’s Ministry of Commerce* and *China’s Statistical Yearbook (1984-2004)*. These sources list the number of foreign firms approved for establishment, their ownership forms and contracted amount of FDI capital, realized amount of FDI capital and the distribution of their national origins by year. The final data contain aggregated observations on the total number of CJVs, EJV and WFOEs as of the end of each year and the contracted amount of FDI capital associated with each observation. A panel database was developed, including data of 15 provinces in the period 1984 – 2003 (300 data points in total). In the panel, we include only those provinces that have complete data, including Beijing, Tianjin, Hebei, Shanghai, Jiangsu, Zhejiang, Fujian, Hubei, Guangdong, Guangxi, Hainan, Yunnan, Qinghai, Ningxia and Xinjiang. At the national level, a total of 922 foreign firms were approved until 1982. By the end of 2003, the total number of foreign firms approved for establishment reached 465,277. Our panel database includes 332,062 foreign firms which account for 71% of the total foreign firms that entered China in the period of the study. The composition of ownership forms has significantly changed over time, as revealed in table 3.1. In addition, data on institutional changes were collected from government archival and documents and other published materials.

Table 3.1 Distribution of the total foreign firms by ownership form

Forms	1982	1985	1987	1990	1992	2003
CJVs	87%	61%	52%	32%	19%	12%
EJVs	9%	37%	46%	56%	65%	51%
WFOEs	4%	2%	2%	12%	16%	37%

Source: China Ministry of Commerce, 2005.

3.3.2 Homogeneity of Entry Modes

The dependent variable of our analysis is homogeneity of entry-mode decisions by foreign firms in China. Homogeneity is always a matter of degree (Powell, 1991). To gain insights into homogeneity of the FDI population in China, the Herfindahl Index is applied. The Herfindahl Index (HI) has been widely used and has proved to be effective in strategy research for measuring industrial concentration (e.g. Acar and Sankaran, 1999). A higher HI refers to a higher degree of concentration. By replacing the market share of a firm in an industry with the proportion of foreign firms taking different ownership forms, we calculate the degree of homogeneity (denoted by DH):

$$DH = \sum (P_{civ}^2 + P_{ejv}^2 + P_{wfoe}^2)$$

Where P_{civ} , P_{ejv} and P_{wfoe} are respectively the proportion of CJVs, EJVs and WFOEs in the population. The DH ranges from $\frac{1}{3}$ to 1. One of the properties of the Herfindahl Index is that it can be used to measure heterogeneity as well by simply reversing it. As homogeneity here is measured as a state, we calculate DH based on density of each community in the population (Carroll and Hannan, 2000; Kuilman and Li, 2006), i.e., the cumulative number of foreign firms by ownership form as of the end of each year.

3.3.3 Independent Variables and Measures

To model the development of homogeneity/heterogeneity, a number of independent variables were introduced. *Degree of deregulation of ownership restrictions* was operationalized as the progress of law enforcement (deregulation) in China. Previous studies often operationalized regulative institutions as state intervention (e.g. Yiu and Makino, 2002). We argue that the progress of law enforcement regarding foreign ownership is more appropriate, as the liberalization in the progress leads to less restrictive regulative institutions, thereby having substantial influence on

organizational choice (e.g. Barnett and Carroll, 1993; Contractor, 1990), which. Since the open-door policy was initiated, the regulatory framework regarding ownership constraints has been substantially liberalized in China (e.g. Fu, 2000; Pearson, 1991). The progress was embodied by two influential laws, i.e. the EJV Law in 1979 and the WFOE Law in 1986. Not until the enforcement of the WFOE Law has the government officially accepted WFOEs. Therefore, the government imposed strong ownership restrictions in the period prior to 1986, but deregulated the restrictions since 1986. We coded the variable as 0 in the period of 1984 – 1986, and as 1 in the period of 1987 – 2003.

Level of the local acceptance of foreign ownership is represented in established market-conforming norms, which was operationalized as the official endorsement of market economy in China. We argue that the endorsement of the market economy better reflects local acceptance of foreign investment and foreign ownership as it embodies many market-conforming values (e.g. Child, 1994; Liang, 2004). Since the economic reform, the normative domain regarding market-conforming values has been shaped in three stages (e.g. Liang, 2004; Howe et al., 2003). China had insisted on a socialist planned-economy till 1984 when the 3rd Plenum of 12th CCPCC (China Communist Party Central Congress) endorsed a socialist planned *commodity* economy. It was not until 1992 that the central leadership had endorsed a socialist market economy. In 1997, the 15th CCPCC decided to convert state-owned enterprises into entities with western-type corporate governance. Therefore, we coded this variable as 0 for the years prior to 1984, 1 for the period of 1985 – 1992, 2 for the period of 1993 – 1997, and 3 for the period of 1998 – 2003.

The collective mindsets of foreign firms regarding appropriate ownership form are operationalized as the dominant ownership form that receives the highest *entry rate* per year. The highest entry rate of one form reflects that the cognitive mindsets associated with it were widely shared by new entrants, which drove them to imitate others (e.g. Lu, 2002). This was measured per province. Each of the three forms, i.e. CJV, EJV and WFOE, can be the dominant form of a year. Therefore, we used three dummies, C-dummy, E-dummy and W-dummy, to code the collective mindsets of foreign firms. The C-dummy was coded as 1 for a year when CJVs were the dominant choice of new entrants, and otherwise, as 0. The E-dummy was coded as 1 for a year when EJVs formulated the highest entry rate, and otherwise, as 0. The W-dummy was coded as 1 for a year when WFOEs achieved the highest entry rate, and otherwise, as 0. In addition, we used a fourth dummy, S-dummy, to reflect the change of the collective mindsets. We coded the S-dummy as 0 for the first year of the observation window. For each of the subsequent years, we then compared the

dominant form of a year with that of the previous year. If they were the same, this variable was coded as 0, and if not, it was coded as 1.

Investment value was operationalized as contracted capital value of a foreign firm (Zhao and Zhu, 1998). This variable represents firm size which was used to capture the effect of a control strategy when transaction costs are considered (e.g. Brouthers and Brouthers, 2003; Gatignon and Anderson, 1988). Average investment value was calculated as that of all foreign firms by the end of each year per province.

Population FDI experience was operationalized as the (realized) cumulative FDI capital per province by the end of each year (Delios and Beamish, 1999; Li et al., 2007). When foreign investors lack local knowledge of the host country, they are more likely to choose joint ventures, but when they have accumulated local knowledge, they are more likely to establish WFOEs (e.g. Chang and Rosenzweig, 2001). Realized FDI capital is thus a means of generating local experience. We calculated this variable as the logarithm of the cumulative amount of FDI.

To control for the effect of economic factors, we further introduced geographical openness, which has substantial influence on the inflow of FDI and ownership choice of foreign firms (e.g. Meyer, 2001; Zhou et al., 2002), and market size which has a positive relationship with the adoption of WFOEs (e.g. Zhao and Zhu, 1998). Geographical openness was measured with the trade value, represented as the sum of imports and exports per province per year. Market size was operationalized as annual provincial GDP (e.g. Gomes-Casseres, 1990; Lu, 2002).

To control for possible temporal effects, we used a set of time dummies for each year. A time dummy was set as 1 for the year it was controlled and as 0 for other years. To control for possible spatial differences across provinces in China, we introduced another set of province dummies for each province. A province dummy was set as 1 for the province it was controlled and 0 for other provinces.

All variables except time dummies and province dummies are summarized in Table 3.2.

3.4 Analysis and Results

Table 3.3 presents the results of OLS models with White cross-section test. In the panel analysis, we take model 1 as baseline model where only control variables are used. Models 2.1-2.5 are established to test the influence of institutional changes on the degree of homogeneity in entry-mode choices of foreign firms in China. Model 3.1 and 3.2 are used to test the effect of strategic considerations on the degree of homogeneity. In addition, we develop models 4.1 – 4.3 to examine the interactive

effect of combining both institutional and strategic factors on the degree of homogeneity. Comparing these models with the baseline, all variables add incremental explanatory power to the degree of homogeneity.

In line with Hypothesis 1, the deregulation or liberalization of foreign ownership constraints appears to have been strongly related to the decreasing homogeneity of foreign firms' ownership forms (negative effect) (Model 2.1). As predicted, with the deregulation of ownership constraints, new foreign firms tend to choose WFOEs, which dilutes the density of joint ventures in the population, leading to decreased homogeneity. In addition, Hypothesis 2 was strongly supported (Model 2.2). As predicted, the increasing local acceptance of foreign ownership, as a result of the adoption of market-conforming norms in China, leads more adoption of WFOEs by new entrants. The increasing number of WFOEs among new entrants dilutes the density of joint ventures in the population, leading to decreased homogeneity as well (negative effect). These findings support previous studies on regulative and normative institutions (e.g. Barnett and Carroll, 1993; Contractor, 1990; Delios and Beamish, 1999; Gomes-Casseres, 1990; Li et al., 2007; Yiu and Makino, 2002).

Hypothesis 3 predicts that changes of the collective mindsets (taken-for-granted beliefs) lead to decreased homogeneity of entry-mode choices by foreign firms in China. It was weakly supported (Model 2.3). The dummy for changes of the collective mindsets (S-dummy) captured this negative effect. A change occurs when the collective mindsets regarding the appropriate ownership form shift from one form to another. The results show that the mindsets associated with CJVs (C-dummy) is positively related to the degree of homogeneity, while the mindsets associated with WFOEs (W-dummy) is negatively associated with the degree of homogeneity. Provided that joint ventures were dominant in the beginning of the observation window, it implies that less new entrants imitated CJVs over time and more imitated WFOEs, which weakens the established homogeneity. The finding is in line with the results of previous studies (e.g. Guillén, 2003; Li et al., 2007; Lu, 2002; Yiu and Makino, 2002) that there is a mimic process in ownership choice. The weak significance of this relationship is probably due to a different approach we took. The previous studies are comparative static while ours is to examine dynamics of the mimetic process. It might be possible that the mimetic process is dominated by other forces in the course, which will be discussed later. However, the adjusted R-square shows that this variable has more explanation power to the degree of homogeneity than deregulation and the level of local acceptance do.

Table 3.2 Descriptive statistics and correlations ¹⁾

	mean	s.d.	1	2	3	4	5	6	7	8	9	10
1. Degree of homogeneity	0.57	0.15	1.00									
2. Degree of deregulation	2.51	0.73	-0.26	1.00								
3. Level of local acceptance of foreign ownership	1.81	0.92	-0.31	0.72	1.00							
4. C-dummy	0.06	0.23	0.15	-0.39	-0.33	1.00						
5. E-dummy	0.67	0.47	0.33	-0.14	-0.30	-0.35	1.00					
6. W-dummy	0.27	0.44	-0.45	0.37	0.51	-0.15	-0.86	1.00				
7. S-dummy	0.12	0.32	-0.05	-0.06	0.04	0.00	-0.16	0.17	1.00			
8. Average investment value ²⁾	1.99	1.65	-0.24	0.12	0.35	-0.16	-0.17	0.27	-0.02	1.00		
9. Population FDI experience ^{2), 3)}	7.45	2.90	-0.44	0.62	0.64	-0.40	-0.27	0.51	-0.12	0.39	1.00	
10. Geographic openness (Trade value ²⁾ /10000)	1.39	3.31	-0.34	0.24	0.34	-0.09	-0.30	0.38	-0.06	0.17	0.50	1.00
11. Market size (GDP ^{3), 4)})	6.67	1.44	-0.25	0.59	0.64	-0.38	-0.15	0.37	-0.11	0.30	0.88	0.52

Note: Time and province dummy variables are available on request.

1) N of year-province observations = 300.

2) million USD.

3) Logarithm.

4) billion USD

Table 3.3 OLS models with white cross-section test (no d.f. correct) and period weights (to be continued)

	Model 1	Model 2.1	Model 2.2	Model 2.3	Model 2.4	Model 2.5
<i>Economic control variables</i>						
(constant)	0.775*** (0.055)	0.753*** (0.004)	0.705*** (0.007)	0.716*** (0.082)	0.716*** (0.057)	0.683*** (0.039)
Geographic openness	-0.016*** (0.003)	-0.018*** (0.003)	-0.018*** (0.003)	-0.015*** (0.003)	-0.017 *** (0.003)	-0.017*** (0.003)
Market size	-0.020** (0.008)			-0.012 (0.010)		
<i>Institutional forces</i>						
Degree of deregulations		-0.048*** (0.004)			-0.032 [†] (0.019)	
Level of local acceptance			-0.032*** (0.002)			-0.022 [†] (0.012)
Change of the collective mindsets ^d						
C-dummy				0.076 (0.049)	0.028 (0.071)	0.028 (0.071)
W-dummy				-0.028* (0.012)	-0.022 [†] (0.013)	-0.022 [†] (0.013)
S-dummy				-0.020 [†] (0.012)	-0.023* (0.011)	-0.023* (0.011)
<i>Strategic considerations</i>						
Control						
Average investment value						
Learning						
Population FDI experience		0.8801	0.8801	0.8882	0.8829	0.8829
Adjusted R-square	0.8711	0.8801	0.8801	0.8882	0.8829	0.8829
Observations	297	300	300	297	300	300

Note: 1) Standard errors in parentheses.

2) Time and province dummy variables are available on request.

3) *** P<0.001; ** P<0.01; * P<0.05; [†] P<0.1.

4) In order to avoid the overlapping effect of three dummies for the collective mindsets, the E-dummy was dismissed in the model.

Table 3.3 OLS models with white cross-section test (no d.f. correct) and period weights (continued)

	Model 3.1	Model 3.2	Model 4.1	Model 4.2	Model 4.3
<i>Economic control variables</i>					
(constant)	0.863*** (0.059)	0.641*** (0.021)	0.801*** (0.008)	0.742*** (0.009)	0.642*** (0.015)
Geographic openness	-0.006*** (0.001)	-0.006*** (0.001)	-0.005*** (0.001)	-0.005*** (0.001)	-0.005*** (0.001)
Market size					
<i>Institutional forces</i>					
Degree of deregulations			-0.059*** (0.002)		
Level of local acceptance				-0.040*** (0.001)	
Change of the collective mindsets ⁴					
C-dummy					0.061 (0.062)
W-dummy					-0.022 [†] (0.013)
S-dummy					-0.023 [†] (0.011)
<i>Strategic considerations</i>					
Control					
Average investment value	-0.007** (0.002)	-0.011*** (0.002)	-0.010*** (0.002)	-0.010*** (0.002)	-0.010*** (0.002)
Learning					
Population FDI experience	-0.024*** (0.006)				
<i>Adjusted R-square</i>	0.9017	0.8973	0.8978	0.8978	0.901
<i>Observations</i>	300	300	300	300	300

Note: 1) Standard errors in parentheses.
 2) Time and province dummy variables are available on request.
 3) *** P<0.001; ** P<0.01; * P<0.05; † P<0.1.
 4) In order to avoid the overlapping effect of three dummies for the collective mindsets, the E-dummy was dismissed in the model.

In Model 2.4, we tested the effect of combining deregulation and the change of the collective mindsets on the homogeneity. In Model 2.5, we tested the effect of combining the local acceptance and the change of the collective mindsets. Hypotheses 1-3 are still supported. But, interestingly, the adjusted R-squares show that the variables of deregulation and the local acceptance do not add more explanatory power to that of the cognitive variable (the collective mindsets) in entry mode choices (in comparison to Model 2.3), while the cognitive variable (the collective mindsets) increases the explanatory power of both deregulation and the local acceptance variables slightly only (in comparison to Model 2.1 and 2.2 respectively).

The estimate of average investment value and population FDI experience appeared to have the expected negative relationship with the degree of homogeneity (Model 3.1 and Model 3.2). This relationship is significant ($P < 0.01$). These two variables added more explanatory power to control variables as the adjusted R-square increases. It demonstrates that foreign firms in China invested with a small scale investment value in the early stage of Reform by which they aimed at learning local knowledge by sharing control rights with local partners (in a form of joint ventures), and over time, foreign firms in China tend to capture full control over the operation by increasing their investment values since they have accumulated enough local knowledge (FDI experience) and therefore shifted their strategic goals to control. This findings is in line with previous research (e.g. Delios and Beamish, 1999; Li et al., 2007; Vanhonacker, 1997) and with Hypotheses 4 and 5.

In order to test the value added of combining institutional theory with a strategy perspective, we developed Models 4.1-4.3 which demonstrate support to Hypothesis 6. In Model 4.1, we tested the explanatory power of combining the degree of deregulation and strategic factors (average investment value). The adjusted R-square is increased as compared with Model 2.1, which suggests that this combination reinforces the explanatory power to the dynamics of isomorphism. In Model 4.2, we tested the explanatory power of combining the level of the local acceptance of foreign ownership and strategic factors (average investment value). The adjusted R-square is increased as compared with Model 2.2, which suggests that this combination increases the explanatory power to the dynamics of isomorphism as well. The same holds for Model 4.3 (in comparison with Model 2.3) in which we tested the explanatory power of combining the change of the collective mindsets regarding appropriate ownership mode and strategic factors. These findings imply that combining a strategic perspective into institutional theory adds more explanatory power of institutional forces to the dynamics of homogeneity. However,

comparing the adjusted R-squares of Models 4.1-4.3 with that of Model 2.2, this value-added is only marginal to the explanatory power of the strategic perspective. This asymmetric effect needs more investigation.

In sum, we find strong supports for our predictions. First, changes in institutional forces lead to the dynamics of isomorphism. The deregulation, the level of local acceptance of foreign ownership and the change of the collective mindsets regarding appropriate ownership mode all lead to decreased homogeneity of foreign firms in China (Hypotheses 1-3). Second, strategic considerations of control and learning by foreign firms in a host country also influence the dynamics of isomorphism. Shift in their considerations between control and learning leads to decreased homogeneity of foreign firms in China (Hypotheses 4-5). More importantly, combining institutional forces and strategic considerations indeed provides us with a better understanding of foreign ownership choice and subsequently the dynamics of isomorphism (Hypothesis 6). These findings explain that it is the *complementarity* of institutional liberalization and changes in strategic consideration by foreign firms over time that determines the shift of the ownership pattern of foreign firms in China from more homogeneity to less homogeneity. The ownership choice of foreign firms in China reflects both legitimacy and efficiency criteria all the time in our observation windows.

3.5 Discussion and Conclusion

The dynamics of isomorphism determined by institutional changes and strategic considerations has received only scant attention in previous organizational choice studies based on institutional theory and studies on ownership choice of foreign firms in a host country. This study investigated how dynamics of organizational homogeneity are related to institutional liberalization as well as strategic considerations of firms entering new contexts. Several hypotheses were tested using data on a population of foreign firms in China. The findings show that the degree of organizational isomorphism is negatively related to deregulation or liberalization of ownership constraints and the level of local acceptance of foreign ownership. This finding is in line with the predictions by Oliver (1992), Powell (1991), and Scott (2001). When entering host countries, foreign firms face institutional constraints which generate isomorphic forces. If institutions change over time, this weakens established isomorphic forces and gives rise to heterogeneity.

The findings of this study also show that the degree of organizational isomorphism is negatively related to the *change* of taken-for-granted

beliefs/mindsets regarding appropriate ownership form, a finding that did not appear in any other study. Previous studies from a static view were unable to tackle this phenomenon (e.g. Haveman, 1993; Lu, 2002; Yiu and Makino, 2002). However, these studies imply that firms may choose different models to imitate depending on which group or community they feel more associated with. In addition, competition among different ownership forms may also lead to different entry rates of each form (e.g. Li et al., 2007). Therefore, cognitive forces may be more complicated than empirically tested in shaping the dynamics of isomorphism. This finding needs more exploration.

In addition, this study investigated how the dynamics of homogeneity are related to strategic considerations by foreign firms. This study examined the population pattern of foreign ownership which goes beyond previous studies that were focused on individual choices (e.g. Agarwal and Ramaswami, 1992; Delios and Beamish, 1999; Gomes-Casseres, 1990; Hennart, 1988, 1991; Luo, 2001a). Our findings confirm those studies from a dynamic view. In the early years of the Reform, foreign firms had no choice but to take a learning strategy to establish joint ventures in which they conceded their control to local partners; over time, after the population FDI experience of foreign firms in China had accumulated sufficiently, more new entrants came to establish WFOE to exercise a control strategy. This suggests an additional underlying logic of isomorphism, strategic isomorphism, as termed by Oliver (1988). Our findings demonstrate that dynamics of isomorphism occur as a result of changes in both institutions and strategic considerations. This finding is in line with the results of past studies by D'Aunno et al. (2000), Kraatz and Zajac (1996) and Palmer et al. (1993) that both market and institutional forces matter in explaining organizational changes. It is also in line with the results of Haveman and Rao (1997) and Rodrigues and Child (2003) that organizations co-evolve with institutional environments.

Our study contributes to institutional theory as well by testing the interaction between institutional factors and strategic factors. The findings show, first of all, that combining institutional factors with strategic factors is better off in explaining dynamics of isomorphism. It suggests that both institutional logic and strategic logic of isomorphism reinforce each other as an explanation for isomorphism, and that they must work together in determining the entry-mode choice. It is in line with the theoretical development in strategy and organization studies (Oliver, 1997; Roberts and Greenwood, 1997). Second, in line with Powell (1991) and Scott (2001), the findings demonstrate that three institutional forces may have heterogeneous influences on organizations. Both regulative and normative forces, as external pressures, are highly related to one another. As Roland (2004) suggested, normative

institutions often change along with regulative (political) institutions, though with a lagging step. However, cognitive force may work in a complicated manner since firms' beliefs may be shaped by different experiences and associated communities. The dominant beliefs may change as a result of competition among different forms. It leads to the third point that the mimetic isomorphism under the cognitive force may not necessarily be a passive process as often assumed in studies based on institutional theory. Our findings show that the cognitive force has (slightly) more explanation power to the dynamics of isomorphism than the regulative and normative forces do. Firms may not necessarily be blinded in imitation. Their taken-for-granted beliefs may reflect just those regarding which strategy is more efficiency in the similar situations to that of others, or those regarding what regulative or normative institutions are determined to conform. In this sense, the cognitive force works at a different level from other forces and is also dominated by other forces, which may reflect the idea of overlapping institutions in Sewell (1992), Whittington (1992) and Seo and Greed (2002).

From the perspective of international business, our study confirms that institutions matter in particular in influencing strategic formulation of foreign firms in transition economies (e.g. Peng, 2003). In such a situation, external legitimacy is crucial for foreign firms to gain for their entry and operation (e.g. Xu and Shenkar, 2002). However, the fact that institutions matter does not turn firms into "institution-takers". Rather, firms attempt to develop the trade-offs in their strategies (e.g. Luo, 2001a), i.e. finding ways to achieve constrained efficiency (e.g. Roberts and Greenwood, 1997). Over time, the deregulation and liberalization in transition economies open more space for foreign firms to practice diverse choices.

One potential limitation of this study is that we use aggregated data instead of data on individual firms, which limits us to use other indicators in the measurement, for example, R&D intensity for control strategy and firm-level experience in the host country for learning strategy. However, we argue this does not matter since our concern is on the aggregated pattern of firms. Another limitation is that we did not consider the adaptation of foreign firms, i.e. whether they change their ownership form after entry. In our study, we assume that the adaptation of foreign firms is inflexible and thus is not considered. This assumption is established for two reasons. On the one hand, foreign firms, once established, can not change their ownership form without costs; and on the other hand, the selective process often dominates the adaptation process in organizational changes (e.g. Haveman and Rao, 1997).

Future research should attempt to explore the interaction between the cognitive force and other forces in depth. The mimetic process due to cognitive pressures is often observed in organizational behaviour (e.g. Haveman, 1993; Lu, 2002;

Mizruchi et al., 1999). Yet, there are also observations that organizations do not follow the dominant form or others, but struggle for a new form in the conditions of uncertainty instead (e.g. Rowan, 1982; Fu, 2000). In the particular context of our study, it is useful to explore further the adaptation process of foreign firms in organizational and strategic choices once they *have entered* the country. It will provide additional insights to the dynamics of isomorphism and the co-evolution of foreign firms with the institutional environment in China.

4 Ownership Choice of Foreign Firms in China: A Process Approach

4.1 Introduction

The ownership choice is one crucial strategy of foreign firms in a host country. This chapter deals in particular with the ownership choice of foreign firms in China by addressing the difference between an *observed* ownership choice and ownership *preference*. We focus on the ownership choice between wholly foreign owned enterprise (WFOE) and equity joint venture (EJV) since these two forms account for more than 90 percent of foreign ownership choices in China. In the pre-entry stage, foreign investors have developed ownership strategy (or ownership preference) that can have higher returns against possible risks. However, the subsequent implementation of ownership choices is confronted with many constraints other than the central regulatory policies in China. For example, seeking, evaluating and negotiating with local partners for cooperation may not be an easy job (Faure, 2000). Foreign investors have also to deal with *local* governments directly, which often have enough leeway to design their own industrial policies as a consequence of decentralization. The frustration of foreign investors is that the information of local partners and the behavior of local governments cannot be learned *ex ante* without direct interactions (or negotiations). These on-site interactions may force them to make adjustment to pre-entry ownership preference. Therefore, the ownership choice of foreign firms in China must be a learning process regarding institutions. What remains to be answered is: what institutions shape their ownership choices and in what kind of learning process are they involved in China?

A stream of research has focused on *what* determines the ownership choices of foreign firms in host countries though with inconclusive findings (e.g. Chen et al., 2002; Delios and Beamish, 1999; Guillén, 2003; Hensiz, 2000; Kogut and Singh, 1988; Malhotra, 2003; Yiu and Makino, 2002; Zhao et al., 2004). Strategically, foreign firms prefer an ownership mode that involves lower transaction costs or generates higher values. Transaction costs are influenced by asset specificity and

uncertainty associated with the investment (e.g. Anderson and Gatignon, 1986; Buckley and Casson, 1976; Hennart, 1988; Williamson, 1985), and moderated by industry characteristics (e.g. Erramilli and Rao, 1993). Values are considered by comparing the exploitation and exploration of organizational capabilities (e.g. Agarwal and Ramaswami, 1992; Madhok, 1997; Teece et al., 1997). However, their choices are often constrained by institutional pressures in particular in transition economies (Meyer, 2001; Xu et al., 2004). These studies all took a “variance” approach, as termed by Mohr (1982). The variance approach is used to examine a correlative relationship among dependent and independent variables, but is unable to identify the interplay among different determinants (Langley, 1999). Due to this weakness of the variance approach, the previous studies demonstrated the correlative relationships between ownership choice and transaction costs, transaction values, or institutional constraints, and the possible various tradeoffs (costs vs. values and efficiency vs. legitimacy) (e.g. Luo, 2001a) in the ownership choices, though they were unable to specify the underlying process of the interplay therein. Therefore, Gomes-Casseres (1990) suggested that the ownership choice of foreign firms needs to consider “what a foreign firm desires to have” and “what a foreign firm can do” separately in two phases, which can (partly) clarify the inconsistent or inconclusive empirical findings where only the observed ownership choices were considered.

The predominant design for this research follows the ‘process’ approach (Langley, 1999; Mohr, 1982). The process approach helps explain the phenomenon by identifying the underlying sequence of events that lead to the outcome (decision). This approach is very insightful in understanding the ‘messy’ field of international business (Parkhe, 1993). The process approach has long prevailed in studying internationalization (Johanson and Vahlne, 1977; Meyer and Gelbuda, 2006; Reid, 1981), which highlights the decision process from concern to perception and to commitment, and that from knowledge accumulation to expansion. Surprisingly, however, few studies on ownership choices took up such an approach. Büchel (2002) demonstrated that the divergence and convergence of different factors shape the development of a joint venture from formation to ownership change and to termination. Tallman and Shenkar (1994) suggested that the formation of international joint ventures (IJVs) needs a process to consider different variables at different stages. Though few in number and with a particular focus on joint ventures, these studies highlighted the insightfulness of the process approach to understanding the ownership choice of foreign firms and the necessary tradeoff between preference and constraints in the decision. From this perspective, therefore, we propose that foreign firms decide on their ownership structure through a learning process in which the tradeoff is managed in two phases. Following Child (2002) who

convincingly demonstrated the usefulness of combining process and variance approaches in studying the configurations of IJVs, we also borrow the fruits of previous variance analysis to construct this process.

The aim of this chapter is to explore the underlying learning process in the ownership choice of foreign firms in China. We have developed this chapter based on a case study of twenty foreign firms in 2004 and 2005. Case study (Eisenhardt, 1989; Yin, 2003) provides detailed process knowledge on ownership choices, which helps us fulfill the goal. Based on our fieldwork in China we claim that (1) the ownership decision of foreign firms is a dynamic process in which foreign investors adjust their preference to the *local* and circumstantial environment, since (2) ex-ante decisions on ownership (preference) cannot foresee all contingencies in the host country, preempt moral hazard once they have invested in one location, and anticipate the speed and direction of changes in policies; (3) in the Chinese context, two factors deserve more attention in the decision: the increasing importance of the *local* as opposed to the national business environment and the importance of *informal* as opposed to formal institutions. Therefore, our study contributes to the theory regarding ownership choice of foreign firms by developing a dynamic view and a process framework that explains how the interplay of preference and constraints leads to an observed ownership structure. In addition, the study contributes to the understanding of the phenomenon by adding a local perspective. Furthermore, the study illustrates the interplay of transaction costs, organizational capability and institutional pressures in the decision-making process, which echoes the recent call for theoretically probing into transition economies (e.g. Meyer and Peng, 2005; Tsui, 2004; Wright et al., 2005). Our study therefore has implications for strategy research in transition economies.

The chapter is organized as follows. Section 4.2 introduces a preliminary conceptual framework from a process perspective based on previous findings. Section 4.3 describes the research design and case studies in China. Subsequently, the findings present the decision-making of the observed WFOEs vs. EJVVs among our cases, which, by analytic induction, help transform the conceptual framework into a context-based analytical framework (section 4.4). Section 4.5 discusses the chapter's contribution to theory, presented in a set of propositions. Section 4.6 forms the conclusion of the chapter.

4.2 Theoretical Background

As noted earlier, we adopt a process approach to explore the ownership choice of foreign firms in China. To do so, we propose a conceptual framework as shown in Figure 4.1 under the assumptions of bounded rationality and sequential stages (Simon, 1960). The framework suggests that the observed ownership of foreign firms is conducted in a dynamic process in which ownership preference is evaluated prior to entry in phase 1, and is adjusted subsequently in phase 2 of on (and post-)entry. The adjustment is particularly necessary in the context of transition economies such as that of China. Institutions not only influence the evaluation of preference but also determine the learning process that leads to the adjustment. In what follows, we develop the meaning of the constructs, i.e. preference and constraints, and provide justification of the process from preference to adjustment or synthesis.

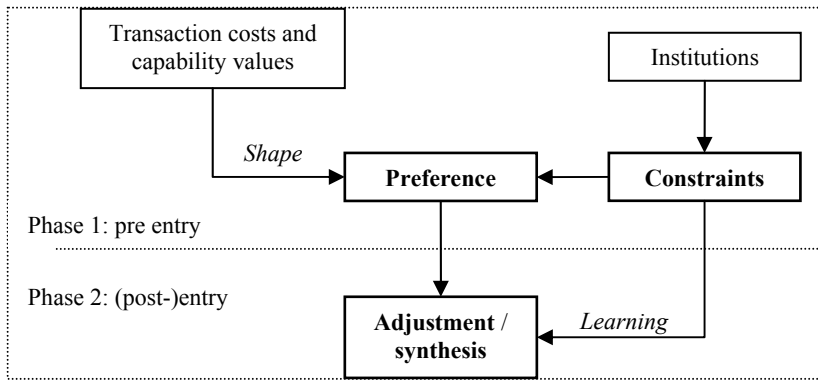


Figure 4.1 Theoretical model of ownership choice of foreign firms

4.2.1 Preference for Ownership Modes

Ownership preference refers to what a foreign firm desires to have regarding the ownership structure, i.e. WFOE vs. EJV, to achieve organizational efficiency and competitive advantages (Gomes-Casseres, 1990). Researchers have identified the determinants of ownership preference from two different perspectives, i.e. transaction cost theory (TCT) and organizational capability approach (OC). It is suggested that the strategy of a foreign firm in ownership preference is to manage the cost-value tradeoff.

From the TCT perspective, a foreign firm prefers an ownership mode that involves the minimum transaction costs, i.e. those of establishing and running the

firm (e.g. Buckley and Casson, 1976; Hennart, 1988). Empirical studies have examined both firm-specific factors and context-specific factors that determine the transaction costs (e.g. Agarwal and Ramaswami, 1992; Brouthers, 2002; Delios and Beamish, 1999; Gatignon and Anderson, 1988; Kim and Hwang, 1992; Kogut and Singh, 1988; Luo, 2001a; Makino and Neupert, 2000; Meyer, 2001; Pan, 1996). The firm-specific factors are those associated with the concepts of asset specificity and contractual hazard, represented with proxies of technology intensity (or proprietary knowledge) and costs of making/enforcing contracts respectively. The context-specific factors are those representing external uncertainty in the institutional environment of the host country, in particular in the context of transition markets (e.g. Meyer, 2001; Williamson, 1991). These factors include the *perception* of political risk and cultural distance. From this perspective, the conventional arguments are as follows: (1) a foreign firm prefers WFOE over EJV when a higher degree of asset specificity and contractual hazard is involved; and (2) a foreign firm prefers EJV over WFOE when a higher degree of external uncertainty is perceived. However, service firms may respond to these transaction cost factors differently in some aspects (e.g. Brouthers and Brouthers, 2003; Erramilli and Rao, 1993). Due to people intensity in service sectors, for example, a service firm prefers EJV when a higher degree of contractual hazard is involved, because the integration gain may not be higher than the internal organizational costs.

In another vein, the OC perspective suggests that a foreign firm prefers an ownership mode that can realize the maximum values for the firm, either in the deployment of existing capabilities or in the development of new capabilities (e.g. Peng, 2001; Tallman, 1991). Empirical studies have examined capability factors that determine the ownership choice of foreign firms (e.g. Agarwal and Ramaswami, 1992; Bell et al., 1997; Brouthers et al., 1996; Chang, 1995; Delios and Beamish, 1999; Luo, 2002a; Kogut and Singh, 1988; Pan, 1996; Shenkar and Li, 1999), which pointed to factors such as capital commitment (firm size), technology or service intensity, international knowledge, and the need for local knowledge (such as local distribution networks). Therefore, the OC perspective predicts that (1) a foreign firm prefers WFOE over EJV when the investment involves a larger size of capital commitment and a higher degree of knowledge intensity; and (2) a foreign firm prefers EJV over WFOE when it has higher demand for local knowledge and local complementary resources.

Both perspectives, while stressing the opposite side of the same coin, are quite complementary to each other (e.g. Langlois and Foss, 1999; Williamson, 1999; Zajac and Olsen, 1993). The two perspectives are developed on the same core concept, though using different terms, i.e. asset specificity vs. resource/capabilities.

In particular, they tend to converge in empirical measurement, for example both measured by the proxy of technology intensity. Therefore, Madhok (1997) proposed that the ownership decision of foreign firms is actually the tradeoff between transaction costs and capability values associated with different modes. From the perspective of a foreign firm, it will have its strategic intent, either the exploitation of the existing capabilities or the exploration of new capabilities for future use. When doing so, it will also evaluate the potential transaction costs of the investment associated with different ownership modes. The overall evaluation leads to the decision that the chosen ownership mode will be the one that is in alignment with the strategic goal (values) AND involves lower transaction costs. In this phase, as implied by the TCT- and OC-oriented studies, institutional factors indirectly shape the evaluation of preference (constraining effect) through for example the *perception* of political risks and the *understanding* of the host country regulations, which will be addressed later in more detail.

4.2.2 Constraints on Ownership Choices

Constraints on ownership choices refer to those that limit what a foreign firm can do regarding the decision (Gomes-Casseres, 1990). These constraints are defined by institutions which are either formal (e.g. laws and regulations) or informal (e.g. conventions, norms and codes of behavior) in the host country (North, 1990). These institutions do not only shape the perception of human beings, as applied in the TCT logic, but also *directly* define the choices that a foreign firm can select from regarding ownership modes, for example. This is particularly relevant in transition economies such as in China where the host government often imposes strong restrictions on foreign ownership (Osland and Björkman, 1998; Poynter, 1985; Vanhonacker, 1997). Therefore, advocates of institutional theory (IT) argue that foreign firms tend to conform in their choices to “what they can do” in the context of facing high institutional pressures, which helps establish the external *legitimacy* for their survival (DiMaggio and Powell, 1983; Kostova and Zaheer, 1999; Peng, 2003; Rosenzweig and Singh, 1991; Scott, 2001).

Empirical studies have examined institutional determinants that force foreign firms to concede their ownership preference (e.g. Contractor, 1990; Davis et al., 2000; Fagre and Wells, 1982; Henisz, 2000; Lecraw, 1984; Lu, 2002; Xu et al., 2004; Yiu and Makino, 2002). Determinants associated with regulative and normative institutions were argued to be most effective in reflecting the institutional environment and tested widely. Regulative institutions are rules and laws that

govern foreign firms in the host country, and thus the regulative pressures are effectively reflected by the host government restrictions and regulative distance between the home and host countries. Normative institutions refer to norms and values that govern the behavior of people in the host country, and thus the normative pressures are empirically measured by the normative distance between the home and host countries, market infrastructure and business routines in the host country. The mimic behavior (e.g. Lu, 2002; Yiu and Makino, 2002) and the bargaining behavior (e.g. Gomes-Casseres, 1990; Lecraw, 1984) of foreign firms under high institutional pressures demonstrate that the constraints directly shape their ownership choices, in which the external legitimacy is valued higher than efficiency (which can be realized by the calculation of costs and values). Therefore, it is interesting to investigate how foreign firms synthesize this direct effect of institutions with the preference evaluation, where an indirect effect of institutions exists, in ownership choice.

4.2.3 Ownership Choice as a Process

It can be concluded that the ownership choice of foreign firms entails various tradeoffs, including costs vs. values and efficiency vs. legitimacy, or more generally, preference vs. constraints (e.g. Hill et al., 1990; Luo, 2001a). They reflect the multiple dimensions of internationalization uncertainty, which require foreign firms to strategically manage them in a synthetic way (e.g. Miller, 1992; Shrader et al., 2000). The reduction of uncertainty in one dimension may lead to the increasing uncertainty on another dimension. Empirical studies have shown that foreign firms indeed decide on their ownership choices by managing the tradeoffs of costs, values, preference, and constraints (e.g. Luo, 2001a).

The tradeoffs involved demonstrate the complexity of the choice. Thus, it is quite hard to accept that foreign firms manage them simultaneously, as the previous integrated approach suggested (e.g. Luo, 2001a; Shrader et al., 2000). Note that people are bounded in rationality and information is incomplete and allocated asymmetrically. Therefore, we argue that the tradeoffs are managed *in a phased process*, more accurately. It can be justified by previous studies on bargaining, partner selections, and experience.

The bargaining approach, while emphasizing the confrontation of foreign firms with constraints regarding ownership choices in the host country (Fagre and Wells, 1982; Gomes-Casseres, 1990; Lecraw, 1984), implicitly suggests that foreign firms have evaluated their ownership preference prior to the bargaining (e.g. Gomes-Casseres, 1990). The negotiation determines to what extent the firm has to adjust

their preference to the local requirement. Studies on partner selection in IJVs look into traits of local partners that can best match the strategic goals of a foreign investor in the IJV (e.g. Hitt et al., 2000; Luo, 1997) with an implicit assumption of EJV preference prior to entry. Note that there may be many local firms having similar traits. Therefore, the establishment of an IJV needs to find the right partner and involves “intense bargaining among prospective partners as well as other stakeholders” in the host country (Tallman and Shenkar, 1994: 99). In addition, experience is also powerful in explaining the ownership choice of foreign firms (e.g. Chang and Rosenzweig, 2001; Delios and Beamish, 1999). Studies on internationalization process suggest that experience with institutions (country- and industry-specific) must be acquired by means of *learning by doing* (e.g. Eriksson et al., 1997; Meyer and Gelbuda, 2006; Shaver et al., 1997). It implies that the working knowledge of local institutions cannot completely be anticipated *ex ante* but needs to be “absorbed” through direct interaction with local institutions.

To summarize, as shown in Figure 4.1, the ownership choice of foreign firms entails a two-phase process to manage various factors in the decision-making. In the pre-entry phase, ownership preference is evaluated based on transaction costs and organizational capability values. The evaluation is moderated by the perception of the institutional environment in the host country (constraining effect). In the on- (and post-) entry phase, ownership adjustment or synthesis is necessitated when foreign firms learn actual constraints by directly confronting (local) institutions. We argue that this process model is particularly applicable in China where formal institutions are weak and informal institutions prevail in doing business (e.g. Boisot and Child, 1996; Krug, 2004; Peng, 2003). The recent survey on investment climates (World Bank, 2005) shows that, although China has made commitments to the World Trade Organization (WTO) by streamlining the FDI regulations at national level, foreign investors still frequently encounter problems, such as ambiguous policy implementation, times and gifts needed for networking with officials, when conducting business at local level. It implies that foreign firms cannot rely on scanning the national-level institutions prior to entry only, but have to interact directly with these local institutions on site in China. It is therefore very likely that this interaction generates the working information on local institutions and eventually leads to ownership adjustment on entry or in the post-entry phase. In what follows we develop a case study in China to flesh out our theoretical model.

4.3 Research Method

4.3.1 Case Study

In this study, we are concerned with the ownership choice of foreign firms in China. Therefore, we are interested in the process of the ownership choices, from pre-entry evaluation to entry adjustment and further to possible readjustment in operation. We sampled cases for ownership mode (WFOE vs. EJV) and changes in decision-making. Twenty cases were selected in six cities. Table 4.1 presents the characteristics of cases studied in the chapter. Our cases include eight EJVs and twelve WFOEs according to current status. One of the EJVs is between a foreign parent and a Hong Kong partner, and others are all between a foreign partner and a local (mainland Chinese) partner. According to the original status of the establishment, our cases include twelve EJVs and eight WFOEs. It means that four foreign firms (Case 2, 14, 18 and 20) changed their ownership mode from EJV to WFOE in the post-establishment stage. One EJV increased its foreign shares from 51% to 80% after three years operation (Case 5). In addition, two EJVs were negotiating on ownership changes when the fieldwork was carried out, one for increasing the foreign share in the EJV (Case 11) and the other for decreasing the foreign share (Case 12). All foreign firms studied except Case 2 and Case 3 operate in one of the development zones.

Our cases are diverse in terms of size, country of origin, and formation year, which permits a cross-case analysis. Eleven cases are large in size in terms of employment or initial investment capital, while the other nine cases are either small or medium in size. The variation in size provides the possibility of examining the effect of using size as a proxy of organizational capabilities, for example. All twenty cases operate in fourteen industries at 3-digit code level, among which sixteen cases are from the manufacturing sector and four from the service sector. Though western firms (12 cases including one Japanese firm) predominate in our sample, which is in contrast to the landscape of foreign firm population in China (Asian firms are dominant), this would not be a problem from the perspective of case study since we are not providing the base for a representative survey but exploring insights from a particular kind of experience (Child, 2002). All of our cases are foreign firms established in a time span from 1992 to 2004, roughly matching the period after 1990 in which 90% of foreign firms started. Lacking cases of foreign firms established in the 1980s might limit the scope of exploration regarding the regulation effects. However, we have one case (Case 5) in which the negotiation for the formation started in 1986, and two cases (Case 7 and Case 15) in a regulated sector. These three cases to a certain extent make up the deficiency.

Table 4.1 Characteristics of foreign firms studied (to be continued)

Case No.	Origin	Location	Year of establishment	Current ownership mode (Foreign shares)	Number employed	Investment capital (million USD)	Industry
1	Netherlands	Shenyang	2004	EJV (51%)	400	29.6	Machinery
2	Taiwan	Dezhou	1993	WFOE (100%)	1200	60	Textile
3	South Korea	Dezhou	1994	EJV (51%)	100	1.4	Electronic devices
4	Singapore	Wuxi	2004	WFOE (100%)	750	81	Electronic devices
5	Netherlands	Suzhou	1994	EJV (80%)	2000	110	Household Electronics
6	USA	Suzhou	1997	WFOE (100%)	60	5	Tools
7	UK	Suzhou	1997	WFOE (100%)	70	135	Pharmaceuticals
8	Taiwan	Suzhou	1999	WFOE (100%)	1500	20	Office equipment
9	Taiwan	Suzhou	2001	WFOE (100%)	3150	100	Electronic devices
10	Taiwan	Suzhou	2001	WFOE (100%)	500	34.5	Auto parts
11	South Korea	Suzhou	2003	WFOE (100%)	500	4	Electronic devices
12	Japan	Hangzhou	1992	WFOE (100%)	2000	21.4	Electronic devices
13	France	Hangzhou	1994	EJV (55%)	110	7.8	Software

Table 4.1 Characteristics of foreign firms studied (continued)

Case No.	Origin	Location	Year of establishment	Current ownership mode (Foreign shares)	Number employed	Investment capital (million USD)	Industry
14	France	Hangzhou	1999	EJV (50%)	50	0.2	Household products
15	USA	Hangzhou	2003	EJV (49%)	2000	340	Communications equipment
16	USA	Hangzhou	2003	EJV (40%)	35	3	Electronic devices
17	Netherlands	Shanghai	1988	WFOE (100%)	250	-	Logistics
18	Netherlands	Shanghai	1998	WFOE (100%)	17	-	Banking
19	Taiwan	Shanghai	1999	WFOE (100%)	4000	50	Electronic devices
20	USA	Shanghai	2003	EJV with HK firm	45	-	Culture

Note: Size is measured by the number of employees and the size of investment capital. Small refers to foreign firms with no more than 100 employees or investment capital of less than five million USD. Medium refers to foreign firms with between 100 and 500 employees and/or investment capital between 5 and 10 million USD. Large refers to foreign firms with more than 500 employees and/or investment capital greater than 10 million USD.

4.3.2 Data Analysis

We followed a synthetic strategy (Langley, 1999) to analyze the case data, attempting to construct the process from detailed case data. It involved an iterative process of analysis (Eisenhardt, 1989; Yin, 2003). From the raw interview data (transcripts), we first generated a series of minicases (Eisenhardt, 1989). Secondly, based on these minicases, we coded “events” (such as preference and adjustment) and variables that described them according to the proposed theoretical framework. Our interview data are highly consistent with archival data. In doing so, we aimed at establishing a general pattern of the decision-making process regarding ownership mode choices in China.

The cross-case analysis followed the method of analytic induction (Cressey, 1953; Yan and Gray, 1994). We started with one case study and the findings were reviewed with regard to whether the proposed process pattern was confirmed or rejected, and then the theoretical model is modified in the view of the findings. The comparison was repeated for all cases. This iterative analysis made the findings better grounded and thus improved the reliability of the findings. The findings of the study are described in what follows.

4.4 Towards a Two-phase Learning Process

The cross-case analysis demonstrates that ownership adjustment is often necessary when foreign investors come to establish their subsidiaries in China. On the basis of this cross-case analysis, we develop a context-based analytical model, shown in figure 4.2, which summarizes our findings regarding the ownership choice of foreign firms in China. The consistent evidence generated from all cases suggests a two-phase (preference-adjustment) learning process which can better describe what institutions influence the ownership choice of foreign firms and what learning process they have to deal with in China. This analytic model extends and fleshes out the proposed framework. In the following, we describe the model with empirical findings generated from the twenty foreign firms in China.

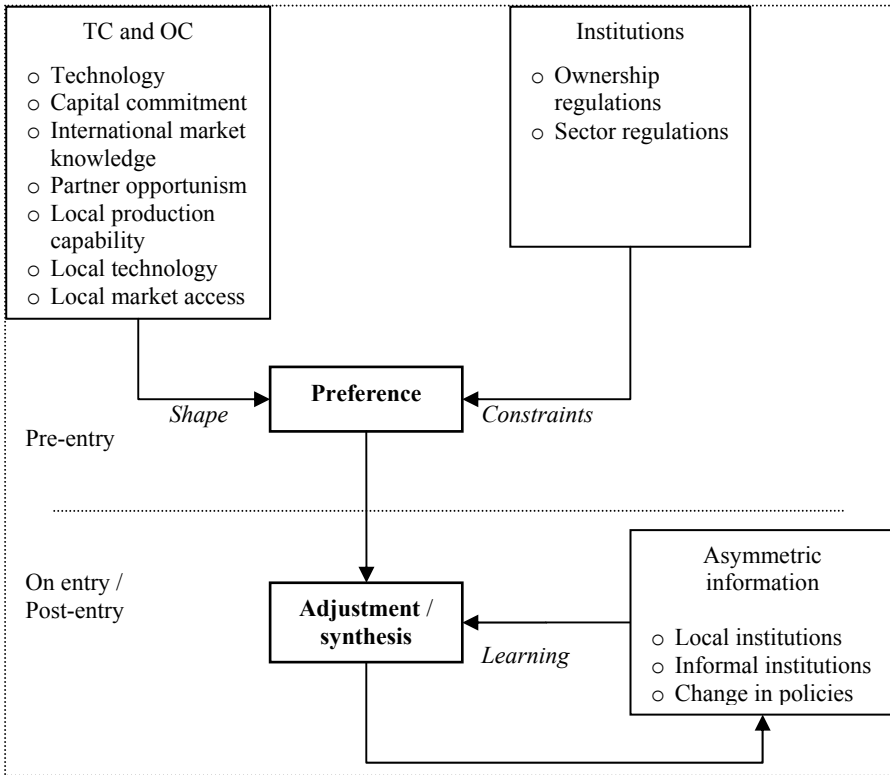


Figure 4.2 Two-phase process of ownership choice of foreign firms in China

4.4.1 Pre-entry Ownership Preference Evaluation

We observed twelve EJVs and eight WFOEs (see Table 4.2) that were established on entry in the formation. However, the ownership structure was not necessarily the same as what they had desired prior to entry. Essentially, foreign partners having strong capabilities or a higher degree of asset specificity desire to establish a WFOE in order to capture all returns generated. This preference may be moderated by considering the institutional environment (such as ownership regulations and policy uncertainty) in China, thus leading to a pre-designed mode of EJV with a dominant or majority share.

Table 4.2 Ownership preference and on-entry adjustment in the cases studied

Case	Pre-entry choice		On-entry adjustment	
	Ownership preference	Constraints	Ownership choice	
1	EJV <ul style="list-style-type: none"> ● Dominant share ● One Beijing partner as priority 	<ul style="list-style-type: none"> ● Weak competence of preferred partners. ● Strong competence of Shenyang partner and seeking for joint ventures. 	EJV <ul style="list-style-type: none"> ● Non-dominant share (51%). ● JV with Shenyang partner. 	
2	EJV <ul style="list-style-type: none"> ● Dominant share 	<ul style="list-style-type: none"> ● Seeking of the local partner for joint ventures. ● Involvement of the local governments in negotiation 	EJV <ul style="list-style-type: none"> ● Lower equity share (75%) than expected. 	
3	EJV <ul style="list-style-type: none"> ● Dominant share. ● With partners in the electronics field in a coastal city. 	<ul style="list-style-type: none"> ● No satisfied partners available in a preferred city. 	EJV <ul style="list-style-type: none"> ● Non-dominant share (51%). ● JV with a Dezhou partner in book retail sector. 	
4	WFOE <ul style="list-style-type: none"> ● Location in Suzhou. 	<ul style="list-style-type: none"> ● Strong competition for preferred treatments in Suzhou. ● Locational competition between Suzhou and Wuxi. 	WFOE <ul style="list-style-type: none"> ● Location in Wuxi. 	
5	EJV <ul style="list-style-type: none"> ● Dominant share. ● One Nanjing partner as priority. 	<ul style="list-style-type: none"> ● Unwillingness of Nanjing partner for cooperation. ● Willingness of Suzhou partner for cooperation. ● Local assets over-valued by the local government. 	EJV <ul style="list-style-type: none"> ● Non-dominant share (51%). ● JV with Suzhou partner. 	
6	EJV <ul style="list-style-type: none"> ● Target at a Guilin partner. 	<ul style="list-style-type: none"> ● Poor financial performance of the Guilin partner. ● Recommendation by a trade partner to Suzhou. ● Friendly investment climate in Suzhou. 	WFOE	
7	EJV <ul style="list-style-type: none"> ● Target at a Chongqing partner. 	<ul style="list-style-type: none"> ● Weak competence of the Chongqing partner. ● Friendly investment climate in Suzhou. ● Brand building of the local government to promote FDI. ● Special promise of the local government in Suzhou. 	WFOE	
8	WFOE <ul style="list-style-type: none"> ● Location Suzhou or Shanghai. 	<ul style="list-style-type: none"> ● Friendly investment climate in the development zone in Suzhou. ● Brand building of the local government to attract Taiwanese firms. 	WFOE <ul style="list-style-type: none"> ● Location in Suzhou. 	
9	WFOE <ul style="list-style-type: none"> ● Location in Wujiang or other development zones. 	<ul style="list-style-type: none"> ● Less competition in the development zone for special treatments. ● Brand building of the local government to attract Taiwanese firms. 	WFOE <ul style="list-style-type: none"> ● Location in the Wujiang development zone. 	

Table 4.2 *Ownership preference and on-entry adjustment in the cases studied (continued)*

Case	Pre-entry choice		On-entry adjustment	
	Ownership preference		Constraints	Ownership choice
10	WFOE ● Location Wujiang or other development zones.		<ul style="list-style-type: none"> ● Less competition in the development zone for special treatments. ● Brand building of the local government to attract Taiwanese firms. ● Supportive role of the local government. 	WFOE ● Location in the Wujiang development zone.
11	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Strong competence of the local partner in technology. ● Willingness of the local partner for cooperation. 	EJV ● Non-dominant share (51%).
12	WFOE ● Location in Shanghai, Shenzhen or Hangzhou.		<ul style="list-style-type: none"> ● Less competition in Hangzhou for special treatments. ● Brand building of the local government to promote FDI. 	WFOE ● Location in Hangzhou.
13	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Monopoly status of the local partner in local market access. ● Willingness of the local partner for cooperation. 	EJV ● Non-dominant share (55%).
14	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Willingness of the local partner for cooperation. 	EJV ● Equal equity share (50%).
15	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Strong competence of the local partner in technology. ● Cooperation seeking by the local partner. 	EJV ● Minority share (49%).
16	EJV ● Dominant share. ● Target partners in Shanghai.		<ul style="list-style-type: none"> ● Unsuccessful partner seeking in Shanghai. ● Investment opportunity seeking of the Hangzhou partner. 	EJV ● Minority share (40%). ● JV with the Hangzhou partner.
17	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Willingness of the local partner for cooperation. 	EJV ● Non-dominant share.
18	EJV ● Target at a local bank.		<ul style="list-style-type: none"> ● Unavailability of qualified local partners according to international standards. 	WFOE
19	EJV ● Dominant share.		<ul style="list-style-type: none"> ● Strong competence of the local partner in distribution channels. ● Willingness of the local partner for cooperation. 	EJV ● Non-dominant share (51%).
20	EJV ● Target at a local partner in mainland China.		<ul style="list-style-type: none"> ● Availability of partners that have strong networks with high-level officials in the sector. 	EJV ● JV with a Hong Kong partner.

TC and OC shape Preference: Evidence showed that both transaction costs (TC) and organizational capabilities (OC) were presented in the preference evaluation of all cases. The measures of both TC and OC referred to technology intensity, capital commitment, brand and international market access, which represent asset specificity and in-house capabilities. These factors have been widely examined in previous empirical studies (e.g. Delios and Beamish, 1999; Luo, 2001a) and have also been taken into consideration by foreign firms we studied. Possessing these resources or assets, foreign investors preferred to have a WFOE or an EJV with a majority share. For example, Case 1, Case 4, Case 5, Case 6, Case 7, Case 8, Case 9, Case 10, Case 12 and Case 13 explicitly emphasized their strength in technological advance and brand, as the informant in Case 5 stated, “We are a leading producer in this sector in the world, with advanced technology and a famous brand. We had long considered establishing our own subsidiary in China before the firm was established.” For the foreign partners in Case 14 and Case 15, their international market networks had much higher values when they considered investing in China. When foreign investors perceive higher behavioral uncertainty (contractual hazard), they also tend to choose WFOE (Gatignon and Anderson, 1988; Kim and Hwang, 1992). In Case 10 and Case 12, the foreign investors concerned the potential conflicts in the EJV operation, and therefore explicitly expressed their preference of WFOE. In Case 2 and 3, the foreign partners preferred an ownership mode with higher control providing the higher risks they encountered in both technology and capital commitment.

In addition, our cases showed that a foreign investor might desire an EJV in order to capture the higher returns from local complementary capabilities, such as local market access, local production capability, and local technology capability, by giving up full control over the firm. The following quote is revealing:

Case 1: “The foreign partner, though having advantages in technology and being a major player in the global market, had very bad performance in China which is the largest potential market especially for middle- and low-end products. The foreign partner used to import the products. In order to get access to the market, it desired to have a local partner which is active in the market and has advantages in production and low-end products.”

Case 18: “Though we established as WFOE, we originally desired to have an EJV in which we can build on capabilities to expand into the domestic market quickly.”

Similarly, the foreign investor in Case 13 sought local market access where the Chinese partner dominated in one regional market within China. In Cases 11 and 19, the foreign investors sought local distribution networks in China. In Case 14, the foreign partner, having international market networks, sought a local partner who had production capability for cooperation. For the foreign partner in Case 15, it was more important to build up technological advantages through cooperation, thus the local production and technology capability supplemented their international marketing capability. Indeed, when foreign investors aim at capability exploration or building in a foreign country, they tend to favor EJV over WFOE (e.g. Luo, 2002a; Madhok, 1997)

Constraints Moderate Preference: No doubt these foreign investors had scanned the institutional environment in China earlier. They knew the establishment of a foreign firm would have to face constraints, such as ownership restriction and local market access imposed by the central government. Therefore, foreign firms tend to formulate the ownership preference which realizes constrained efficiency. Case 17 and Case 20 are typical provided that they entered the sectors where WFOEs were not allowed. In such a situation, foreign investors tend to comply with regulations in order to gain legitimacy (e.g. Fu, 2000; Gomes-Casseres, 1990; Peng, 2003; Vanhonacker, 1997). Both informants mentioned that “we knew that we can only establish an EJV by law. So we take it”. Similarly, the informant of Case 7 echoed that “we entered into a sector that is highly regulated. Therefore, we originally attempted to negotiate on an EJV in another locality”. From this perspective, Case 5 is more revealing. The EJV was negotiated just before the WFOE Law was issued by the government. The foreign partner knew it would be hard, if not impossible, to establish a WFOE in China. The informant expressed,

“We were welcomed by the central government for investing in China. However, the central government was restrictive in the approval of foreign firms. In order to increase the credibility, we promised to establish an EJV, transfer technology to the local, and develop exports. After the establishment, the central government once came to check the status of technology transferring...”

In sum, our cases confirm that ownership preference is shaped by transaction costs and capability values, and constraints in the institutional environment as well. In China, the constraints come particularly from the perception of ownership regulations and sector regulations. The intelligence regarding the institutional environment may moderate the preference shifting from WFOE towards EJV, for

example when entering a regulated sector. These findings were verified by our interviews with the regional headquarters of MNCs in China. The informants from the headquarters confirmed that they do not always insist on WFOE, and sometimes prefer to establish EJVs. As one informant remarked, “why should we establish a WFOE if the local partner has more, e.g. technology and market access, to offer.” Another informant confirmed the regulation effect in the remark: “we originally considered an EJV in insurance sector since WFOEs are not allowed according to the central policy.”

4.4.2 On-Entry Ownership Adjustment

The on-entry ownership adjustments in our cases are summarized in table 4.2. Though foreign investors had considered the constraints of the institutional environment when they formulated their entry strategy and ownership preference, evidence showed that the preference is always subject to adjustment on entry when foreign investors come to China. The synthesis or adjustment was arrived at by a learning process in which foreign investors directly interacted with local institutions (see Table 4.2). Most revealing is Case 5 in which the establishment of the EJV had to adapt to local circumstances such as government intervention, availability of local partners and their motivation for cooperation. In this case, the implementation of the EJV was finally done with adjustment in local partner and equity shares. In addition, Case 20 proved that the establishment of the EJV succeeded only when the foreign investor found a local partner that had networks with the government which helped to obtain the operation license in the regulated sector. In other words, the implementation of foreign firms’ ownership preference is constrained practically by (local) governments, potential partners, and informal institutions, which entails intense on-site negotiations with various parties, making foreign investors concede their ownership preference to the circumstances (e.g. Büchel, 2002; Gomes-Casseres, 1990; Meyer and Nguyen, 2005; Tallman and Shenkar, 1994).

The direct learning process generates useful working knowledge on local institutions, which goes beyond the perception based on economic intelligence. In Case 1, Case 3, Case 5 and Case 18, the foreign investors all preferred to establish an EJV prior to entry, but encountered the problem of finding partners when they came to implement entry strategy, leading foreign investors to adjust their choice in terms of preferred partners. As a result, foreign investors may find a partner that was not most desired prior to entry (Case 1 and Case 5), or find an alternative (which was not considered at all prior to entry) unexpectedly (Case 3), or find no one at all

(Case 18). In Case 1, the foreign partner established the EJV with the current partner who is one of the leading players in the domestic market, only after negotiating with many other small and medium enterprises. In Case 5, the foreign partner encountered the unwillingness of the most desired partner to cooperate, leading to the EJV with the current partner. The story went differently in Case 3 and Case 18 where the availability of qualified partners forced the foreign investors to adjust their original preference. While the foreign investor in Case 3 finally selected a partner without any desired experience of electronic device production but with good political networks, the foreign investor in Case 18 had no choice but to establish a WFOE, as is demonstrated in the quotes:

Case 3: *“The foreign investor wished to establish an EJV in one of the coastal cities, and had spent time investigating and negotiating with many potential partners there. The result was disappointing. On his way back, he dropped by Dezhou. One of his Chinese friends asked his friend, who was general manager of a book shop in the city, to have a dinner with him. This friend invited a few city officials together to have dinner with the foreign guest. Through conversations at dinner, the foreign investor was impressed by his managerial capability, networks and personality, thus decided to establish an electronic device factory in cooperation with his shop.”*

Case 18: *“We originally desired to establish an EJV. However, on entry when we sought partners, we realized that there were no qualified partners available according to the international standard. Therefore, we had to change our mind and established a WFOE. In the future, an EJV is still an option.”*

In addition, evidence showed that many EJVs were established through a mutual search process. It pointed to the importance of motivation of local partners for cooperation (e.g. Shenkar and Li, 1999). For example, in Case 1, 2, 13, 15 and 16, the local partners were also seeking cooperation either for new investment opportunities or advancing their own capabilities. In Case 1 and Case 15, local partners desired to have access to the global market (in a rapid fashion). In Case 13, the local partner wished to learn new technologies through cooperation with a foreign manufacturer. In Case 16, the local partner was looking for new investment opportunities. Very often, those local firms seeking foreign partners for cooperation are local winners in terms of economic performance, and their pursuit is encouraged by local governments. As a result, when foreign investors encountered this kind of local partner, they had to negotiate hard and compromise on control in order to make cooperation happen (e.g. Büchel, 2002), as suggested by the following quote:

Case 15: *“Both partners were looking for cooperation on the market in order to increase the competitiveness. Both partners are complementary with respect to resources and capabilities. The foreign partner has a well-known brand and international market networks, while the local partner is strong in technology and products. At the beginning, the foreign partner desired to have dominant control in the firm. However, when it negotiated with the local partner, the local partner insisted on at least having a majority share in the EJV given its technology advantage. Hard negotiations led to a compromise by both partners. The local partner captured control through a majority ownership (51%), but promised that the foreign partner has the right to buy out some shares after two years.”*

For those observed WFOEs except Case 18, evidence showed that their establishment benefited from the motives of the local governments, location competition and networking effects. Local governments often work on “two legs” to attract and compete for FDI, building up the investment climate on the one hand and actively contacting desired investors by means of the investment promotion office on the other hand. The three WFOEs (Case 6, 7, and 12) were established just after the development zones where they registered were officially opened. At the early stage of the development zones, the local governments often urged the provision of high incentives to attract FDI in order to generate an agglomeration effect for the future (e.g. Ng and Tuan, 2001). Therefore, the foreign MNCs with higher profiles (such as good brand, high technology) were often targeted as potential entrants. They often received preferential treatment (e.g. Peng, 2000) such as approval of WFOE status which is otherwise hard to fulfill, as is shown in the following quotes:

Case 6: *“We originally negotiated on an EJV in another locality. It failed because we found that the local partner had serious financial problems. In 1997, one Singaporean trading partner recommended to us to establish a firm in the zone. We came to investigate the investment climate and learnt that the local government is supportive and provides high incentives for desired entrants as well. Therefore, we decided to establish a WFOE in the zone, the approval of which was facilitated by the local government. At that moment, we were the first mover, among our global competitors, to invest in China in the sector.”*

Case 12: *“The local government desired to have high-tech foreign firms established in the newly-opened development zone, which would help promote the zone for FDI. We are the first foreign firm in the development zone. In particular, we have a well-known brand and produce high-tech products. In the interaction with the local government we also knew that we could enjoy more beneficial treatment when there were still only a*

few foreign firms. Therefore, when we became established as WFOE the local government facilitated approval.”

The WFOE in Case 4 was the result of production expansion of the parent’s first subsidiary in Suzhou, but was established in the development zone in Wuxi. Its establishment was benefited from the location competition between development zones. The informant pointed out that “Our firm size is relatively large in the current zone, but it is not significant in the previous zone. Therefore, our requests can be easily fulfilled here.”

The story is more striking in Case 7. In this case, the foreign investor entered a regulated sector where WFOEs are not allowed. However, with the help of the local government and networking, the WFOE was approved by the central government as a special arrangement. It is evidenced by the informant’s words:

“We originally considered an EJV in another locality. But later we moved to the development zone. The reasons are multi-faceted. First, the zone attempted to attract large FDI, especially those from well-known MNCs by offering better treatment. Second, and more importantly, the local government promised to help us establish a WFOE when we promised to commit a large capital investment. The zone is one window of China to attract FDI. Therefore, the central government is also concerned with its performance with respect to the quality and amount of realized FDI, especially at the early stage of the development. The local government consulted with and contacted the central government for this project, and finally the project was specially approved by the ministry as the first WFOE in the sector in China”.

In China, indeed, the fiscal decentralization drives the location competition, and hence local governments have incentives to bargain with the central government regarding policy implementation that meets their local conditions (e.g. Peng, 2000; Segal and Thun, 2001). Only through direct interactions can foreign firms make better sense of the local context and learn how to leverage on local governments, very likely leading to subsequent ownership adjustment.

4.4.3 Post-entry Ownership Readjustment

Learning is an ongoing process (e.g. Büchel, 2002). During the operation, investors may encounter policy changes in the dynamic economic transition or partners may prove to be unsustainable (e.g. inability of one partner to continue making its

commitment or opportunism in cooperation). These experiences trigger the related parties to reevaluate the selected ownership mode, which may lead to re-adjustment of the choice. This readjustment may not often occur in many firms, but it does shed light on the learning process regarding local institutions. The post-entry ownership readjustments in our cases are summarized in table 4.3.

Table 4.3 Post-entry ownership readjustments in the cases studied

Case	On-entry choice	Post-entry readjustment	
	Ownership mode	Constraints	Ownership mode
2	EJV ● Majority equity share (75%).	● Inability of the local partner to make further financial commitment. ● Suggestion of the local government.	WFOE
5	EJV ● Non-dominant share (51%).	● Opportunism of the local partner in profit allocation.	EJV ● Dominant share (80%).
11	EJV ● Non-dominant share (51%).	● Conflicts in operations and about investment decisions.	WFOE
13	EJV ● Non-dominant share (55%).	● Complaints by the local partner about opportunism of the foreign partner. ● Tension between two parties in investment decision making.	Negotiation on possible decrease of foreign equity shares.
14	EJV ● Equal equity share (50%).	● Inability of the local partner to make continuous financial commitment.	Negotiation on possible increase of foreign equity shares
17	EJV ● Non-dominant share.	● Changes in policy allowing WFOE in the sector.	WFOE
19	EJV ● Non-dominant share (51%).	● Conflicts about product brands. ● Neither party wished to compromise.	WFOE

We observed ownership changes in operation in five cases. Case 2, Case 11, Case 17 and Case 19 changed from an EJV to a WFOE, and in Case 5, the foreign ownership share was increased. Additionally, we observed two potential changes that were under negotiation. In Case 13, the foreign ownership share is likely to decrease, and in Case 14, the foreign ownership share will be increased. Evidence showed that the re-adjustment can be achieved in response to policy changes (Case 17). Policy changes frequently take place in China as a result of the pragmatic approach to economic transition. After the ownership restriction was largely released in 1990s, some established EJVs tend to reorganize into WFOEs

(Vanhonacker, 1997). Evidence also showed that re-adjustment may be a response to conflicts with local institutions. These conflicts could not be ex ante anticipated. Over time, “the initial conditions may prove to be unsustainable [and] the local partner may prove unable or unwilling to join in financing subsequent expansion.” (Child, 2002) Thus, in response to these changes, EJVs are triggered to restructure themselves (Yan and Gray, 1994).

In Case 2, the foreign equity share increased from 75% to 100% (WFOE) in 2003 when the local partner encountered serious financial problems and thus was no longer able to commit to the cooperation. Therefore, the local partner, as a state-owned enterprise, reported to the local government. Subsequently, the local government suggested the foreign partner should buy it out. As the informant stressed, “The foreign partner has the priority of buying out according to the agreement but does not have to do it. However, it is wise to follow the suggestion of the local government.” Similarly, in Case 14, the local partner was considering investing in other businesses and therefore partly withdrawing from the cooperation in order to get additional capital. The foreign partner had accepted it and they were negotiating on a renewed agreement.

In Case 19, both partners could not agree on the brand name because each party desired to stress their own brand. Therefore, in order to reduce the conflict in the future, the foreign investor bought the shares out and turned the EJV into a WFOE in 2001. The informant in Case 11 also confirmed that conflicts between the two partners led the foreign partner to take over full control of the firm by turning it into a WFOE. Case 5 is more revealing. In this case, the foreign partner encountered opportunistic behavior on the part of the local partners, which created conflicts among them. Therefore, the foreign partner urged the capture of more control over the operation in order to safeguard the business. The readjustment is evidenced by the quote:

“In the first two years of operation, the local partner was not satisfied with the low performance. It was unexpected for them. Therefore they asked for financial compensation. When the firm started to profit in the third year, the local partner wanted to both keep the compensation and claim the profit share. We could not accept such opportunistic behavior. One solution was to gain a higher control over the operation. Therefore, we negotiated with the local partner and local government on the possible change in ownership structure. It was not easy. Finally we increased our share from 51% to 80% and captured the full control in operation, but on the condition that the compensation agreement remained.”

The foreign investor in Case 13 encountered the complaint from the local partner about its opportunism. In this case, the local partner was not satisfied with firm performance with respect to technology transfer and product development, and therefore fought to increase their shares to avoid intervention from the foreign parent, which is revealed by the quote:

“The foreign partner was concerned only with local market access by taking advantage of us, but acted very slowly in terms of product development and technology transfer. When we reported new product plans to the foreign headquarters, they were always careless and reacted very slowly, which made us miss a few opportunities. On a few occasions, the Headquarters even broke their promises. We, the local side, have the management right, but we do not have the final decision right for investment since we have only a minority share in the EJV. Therefore, we have been urged to increase our shares in the EJV in order to better manage the business. The Headquarters orally agreed to it. But the agreement will take time to be implemented.”

Taking the on-entry ownership adjustment and post-entry readjustment in our cases together, it is confirmed that a problem of information asymmetry occurs in all cases regarding the institutional environment in China at the local level, which is the information regarding local institutions (firms and local governments), informal institutions (e.g. their attitudes and motives), and policy implementation and changes. Therefore, the envisaged ownership preference of a foreign firm often encounters difficulty in implementation, which entails adjustment for the establishment in the on- (and post-) entry stage (e.g. Büchel, 2002; Tallman and Shenkar, 1994).

The two-phase process model provides a synthesized approach to the ownership choice of foreign firms in China. It not only confirms that the ownership choice indeed reflects the various trade-offs (e.g. Luo, 2001a), but it is more insightful since it specifies the underlying learning process in the ownership choice. The host country institutions of China influence the ownership choice of foreign firms in two phases. In the first phase of pre-entry, the national, formal institutions (laws and regulations) shape the evaluation of ownership preference by foreign investors. In the second phase of on- (and post-) entry, foreign investors would find their knowledge of China to be insufficient, in particular those at local level. The consistent evidence shows that foreign investors acquire knowledge on site by direct interactions with institutions at local level. Only through direct interaction can foreign investors learn the attitude and motives of the local government regarding

FDI, and only in so doing can foreign investors negotiate on specific arrangement. In addition, in the case of establishing EJVs, foreign investors have to make direct contact with potential partners in order to learn about their willingness for cooperation and their competence. As our cases show, it is the learning process regarding information asymmetry at local level that makes foreign investors *ex post* “absorb” the actual constraints for establishment and operation, and subsequently adjust their ownership preference to the choices that we observe in foreign firms. However, we do not claim that all the factors specified in the model will be presented in every ownership choice. Rather, we claim that the model provides a pragmatic explanation of the ownership choice of foreign firms in China and suggests which factors one may have to consider and when.

4.5 Discussions and Propositions

Our findings demonstrate that the process approach is very insightful, which helps to identify “events” that lead to the choice. Two “events”, preference and adjustment, are recognized as two phases in the ownership choice of foreign firms in China, which are shaped or constrained by various variables. These findings distinguish between “what a foreign firm desires to have” (preference) and “what a foreign firm can do” (what we observed) regarding ownership choices, leading us to reconsider the previous studies based on variance approach. From this new perspective, previous studies based on a variance approach mainly explained the first phase of preference evaluation but were silent and unable to explain the subsequent ownership adjustment. It is one reason why the previous findings are often inconsistent and inconclusive.

Many studies in international business, including those on ownership choices, recognize the significance of institutions in the host country or in China in particular (e.g. Child and Tse, 2001; Peng, 2003). However, their focus is on the national level, which does not fully characterize the Chinese feature. In China, localities and local institutions matter very much (e.g. Krug, 2004; Qian, 2002). More striking is that informal institutions prevail in doing business (e.g. Boisot and Child, 1996; Krug, 2004). In addition, domestic firms are not necessarily passive “role takers”, i.e. taken into cooperation by foreign investors, and rather they may also be active “role makers”, i.e. seeking cooperation with foreign investors (e.g. Shenkar and Li, 1999). Our study has fruitfully incorporated the local perspective into the learning process. The local perspective calls for attention to the problem of information asymmetry, which helps to explain why ownership adjustment is necessary, what institutions

matter to the choice, and what choice can be realized. It is this local perspective that makes the process dynamic and lively, which also explains from where foreign investors gain their knowledge about a host country. Therefore, adding a local perspective complicates the process, but has high value for our understanding of the ownership choice of foreign firms and of international strategies in general (Ma and Delios, 2007; Meyer and Nguyen, 2005). In what follows we attempt to incorporate existing studies into the two-phase learning process, and subsequently advance propositions for the future rigorous test.

Ownership choice as a process: Our findings explicate the learning process of ownership choices of foreign firms in China, which was regarded as a ‘black box’ in previous studies with the assumption that decision-makers consider all information simultaneously. A few studies recognized the complexity in the ownership choice, arguing for an integrated approach to the phenomenon (e.g. Hill et al., 1990; Luo, 2001a). However, these studies did not, and were unable to, explain the difference between the observed ownership choice and ownership preference of a foreign firm. Gomes-Casseres (1990) suggested that, given the bounded rationality of decision-makers, the ownership choices may involve two interactive processes, i.e. ownership preference and ownership concession. Our findings complement Gomes-Casseres’s suggestion, and demonstrate that foreign firms indeed follow these two sequent processes in the ownership choice when entering China. Various factors work in different phases in different way. Before entry, foreign investors have evaluated their ownership preference considering their global strategy, technology input, capability values, and the host country regulations. Yet, they may have to adjust the preferred ownership mode on site after learning actual institutional constraints generated at the local level, the information of which (e.g. enforcement of institutions, motives and attitudes) is deeply embedded locally and not possible ex ante acquired (Krug, 2004). For example, absence and unwillingness of reliable partners would make an EJV impossible (Case 18); positive attitude of the local government may make impossible things (WFOE) possible (Case 7). Therefore, it can be proposed that:

Proposition 1: The ownership choice of a foreign firm in China is made through a process in which the preference evaluated by the Headquarters outside of China is likely to be adjusted subsequently on site in China.

Preference: Previous studies have largely focused on ownership preference by drawing on insights from TCT and OC. Though with different focuses, many have

argued that these two approaches are more complementary in explaining strategic choices (e.g. Williamson, 1999; Zajac and Olsen, 1993). Therefore, as Madhok (1997) argues, foreign firms tend to balance transaction costs and capability values in choosing ownership modes. Our findings confirm these studies, showing that when exploiting existing technology with a fear of value erosion, foreign firms prefer WFOE (Case 12); when aiming at exploring new capabilities, they prefer EJV (Case 1, 11, 15, 19). However, as theorists would argue, preference is often developed as constrained efficiency (e.g. Martinez and Dacin, 1999; Roberts and Greenwood, 1997). Therefore, preference evaluation must be influenced by external constraints. Indeed, as our findings show, foreign firms tend to take EJV as default choice when they face high ownership restriction or enter into a regulated sector (Case 5, 7, 17, 20), in which the legitimacy demand shaped their preference. Therefore, our findings evidence that, in China, ownership preference is evaluated on TC, OC and constraints altogether.

Over time, the choice of WFOEs has gained legitimacy in China (Li et al., 2007). Since 1990s, the ownership restriction has been largely released, leading to the increase in the number of WFOEs (China Ministry of Commerce, 2005; Vanhonacker, 1997). These observations suggest that foreign investors in general wish to establish WFOEs which offer higher returns from operation in China. The recent trend of acquisition in China implies that foreign investors do not have to rely on cooperation to get access to local market, and instead can make a fast move by means of acquisition. It suggests that, with the increasing openness of China after the WTO accession, more and more foreign investors formulate their ownership preference based on efficiency criteria instead of legitimacy criteria unless the external legitimacy is highly demanded in certain regulated sectors such as pharmaceutical, insurance, and media. In addition to changes in the FDI policy, foreign investors gradually take more consideration of domestic industry development in China. Chinese firms have developed their advantages in technology as well, especially in electronics and ICT sectors (e.g. Amighini, 2005). Many firms in the sector have become globally-oriented, such as Huawei and Lenovo, seeking to exploit their technology advance and explore international markets. Their technology capabilities may be very complementary to those of foreign investors (Case 1 and 15), and thus they seek and are sought for cooperation by foreign investors. In this sense, foreign investors do prefer EJVs in certain situations, but do not establish an EJV simply for general local knowledge, instead more for specific technology-related knowledge that supplements to their technology. In this case, EJVs will offer higher values for foreign investors in building new capabilities. Therefore, it can be proposed that:

Proposition 2.1: In the pre-entry evaluation, foreign investors take EJV as default choice in China only when (1) entering into a regulated or monopolized sector; (2) entering into a market niche where local firms are prospering and globally-oriented, and have the advantage in (complementary) technology.

Proposition 2.2: In the pre-entry evaluation, foreign investors are more likely to take WFOE (acquisition or Greenfield establishment) in China when they perceive a lower degree of regulatory constraints.

Adjustment: Our findings highlight the process of ownership adjustment. Though previous studies taking a bargaining perspective (e.g. Gomes-Casseres, 1990; Lecraw, 1984) or relying on IT (Lu, 2002; Xu et al., 2004; Yiu and Makino, 2002) are also concerned about “what a foreign firm can do” in a host country. However, they presume an existing preference. On the other hand, they are concerned with the host country as a whole, using aggregated information as a proxy of constraints. They measure the institutional constraints by state influence, regulative distance, normative distance and cultural distance. We argue that this kind of knowledge contributes only to the evaluation of preference, does not explain on-site adjustment. The knowledge such as how institutions are actually enforced can only be acquired through direct interactions after entry. In China, in particular, formal institutions are weakly enforced and informal institutions prevail (e.g. Boisot and Child, 1996), and localities matter in doing business (e.g. OECD, 2005; Krug, 2004). These issues are nearly absent, or at least not taken to the core, in the previous studies on ownership choices. However, studies on IJVs draw attention to local institutions such as domestic firms as potential partners, and they imply the possible ownership adjustment as a result of partner selection and negotiating with partners and other stakeholders (e.g. Büchel, 2002; Luo, 1997).

Our findings emphasize the effects of both local institutions and informal institutions on the ownership adjustment in China. First, local governments matter since they interpret and implement the central policies, and sometimes circumvent them to their interests (e.g. Segal and Thun, 2001). Therefore, there is tension between formal rules and self-motives (attitudes). Local governments may seek leeway to make special arrangements regardless of the formal regulations, which are often targeted at desired MNCs (Case 7 and Case 12). In so doing, local governments not only facilitate the implementation of ownership preference by foreign firms (Meyer and Nguyen, 2005), but also reinforce the competitiveness of the locality by nurturing agglomeration of well-known MNCs and develop their own

(political) performance as well. In addition, foreign investors have to confront domestic firms when seeking collaborating partners (Meyer and Nguyen, 2005; Shenkar and Li, 1999). Criteria may include at least competence and willingness of local partners. Finding a match takes time and involves intense negotiations (Case 1, 3, 5). No match may also be the case (Case 18), more particularly in sectors such as banking where there exist only a few state-owned enterprises and their governance reform lags far behind other sectors such as electronics and ICT. In contemporary China, the presumed technological advantage of foreign investors is often challenged by those local firms with technological advantage and actively seeking cooperation as well. Therefore, the ownership choice of foreign firms in China is often subject to adjustment after direct confrontation of (local) institutions (learning effect). Thus, it can be proposed that:

Proposition 3.1: In a non-regulated sector in China, the ownership preference of WFOE is only subject to adjustment when *local* governments are restrictive.

Proposition 3.2: In a regulated sector in China, the ownership preference of WFOE is negotiable when (1) the foreign investor makes large commitments, and (2) the investment is desired by the locality.

Proposition 3.3: The ownership preference of EJV is likely to be changed to WFOE when the entered non-regulated sector in China is structurally weak.

Proposition 3.4: The ownership preference of EJV is likely to be adjusted regarding share structures in China when local potential partners have sufficient bargaining powers.

Readjustment: Ownership readjustment may occur and is necessary when the previous arrangement is found not to be sustainable (Büchel, 2002; Child, 2002). Our findings confirm theirs. However, previous studies departing from a foreign perspective often acknowledged the problems associated with local partners who may prove to be unreliable or unable to maintain the cooperation. The same was found in our cases as well (Case 2, 5 and 19). Our findings suggest that, from a local perspective, foreign partners may also create similar problems. In Case 13, the foreign partner is concerned with market access only in operation, while the local partner is concerned with technology transfer and new business opportunities. The diverging interests led to conflicts over time in decision-making which forced the local partner to renegotiate on the ownership structure. In addition, foreign firms may also seek to establish WFOEs in order to capture the full control once the related policy makes it possible (Case 17) (Vanhonacher, 1997). Therefore, it can be proposed that:

Proposition 4.1: The ownership mode of foreign firms is likely to be readjusted from EJV to WFOE in China when (1) the sector regulation is released, AND (2) the foreign investor prefers WFOE to EJV.

Proposition 4.2: The ownership structure of EJVs is likely to be readjusted in China when (1) either partner fails to make its commitment, AND (2) the other partner has sufficient bargaining power.

The adjustment and readjustment are related to studies on experience in international business. Our findings comply with them regarding the learning process. Foreign investors expand from one country to another or increase their commitment in one country depending on their direct experience there (e.g. Jahanson and Vahlne, 1977; Meyer and Gelbuda, 2006; Meyer and Tran, 2006). Previous studies on ownership choices have considered the effect of experiences, but more that of the corporate (foreign parent) as a whole in one specific country (e.g. Chang and Rosenzweig, 2001; Delios and Beamish, 1999; Guillén, 2003). We argue that the previous experience of the corporate only plays a role in shaping the ownership preference. Our findings further illustrate that the *direct* experience, through learning by doing, of the foreign investor when establishing a specific subsidiary plays a larger role in the ownership choice, which forces the investor to make the necessary adjustment regarding the ownership structure. The direct experience of interacting with (local) institutions generates knowledge regarding how institutions are actually enforced, what institutions matter, and how local governments and firms actually behave in China. Therefore, it can be proposed that:

Proposition 5.1: Foreign investors that are willing to learn about local institutions and informal institutions on site are more likely to make ownership adjustment when establishing a firm in China.

Proposition 5.2: Foreign investors rely on others' experience in China to evaluate the ownership preference but rely on direct experience in China to adjust the ownership choice.

4.6 Conclusion

The findings of this cross-case analysis demonstrate that what we observe as ownership choices of foreign firms often differ from what they desired to have prior to entry. This study enriches our understanding of the phenomenon and advances the

theory of ownership choice of foreign firms, providing a dynamic view of the two-phase learning process from preference to adjustment by incorporating previous findings. The ownership adjustment is necessitated due to information asymmetry at local level in China.

This local perspective makes the model very China-specific. For example, functioning of local institutions and the interplay between formal and informal institutions may not be the same in another setting. This feature may be the limitation that affects the generalization of the findings. However, we argue that the content of the process may be too China-specific, but the structure of the process is likely to be generalized to other contexts. A similar process perspective has already been implied by the bargaining approach (e.g. Gomes-Casseres, 1990; Kobrin, 1987) and studies on IJVs (e.g. Tallman and Shenkar, 1994) in other settings.

This chapter helps us clarify one puzzle in the phenomenon, i.e. the difference between ownership preference and observed choice, and the propositions will guide future investigation into the phenomenon. In addition, this study can be extended through several avenues. First, studying the failures of the establishment of foreign firms can help reinforce the explanatory power of the process model, by looking into whether the failure is due to the lack of learning effect. Second, taking WFOEs through acquisition into the analysis and distinguishing them from WFOEs on green-field can add additional insights into the process model. Third, a comparison between manufacturing and service firms will be needed to sort out the relative weight of different factors in different sectors in China. Fourth, the process that constructs the interplay between transaction costs, organizational capabilities, and institutional constraints can be applied to study other strategic issues of foreign firms in China, such as value-chain relationship and governmental relationship. All in all, this study calls the attention of foreign firms to local institutions, largely ignored, when entering and operating in China. This process approach not only emphasizes the significance of (local) institutions in strategizing but also characterizes the feature of their interplay with other economic factors in transition economies such as in China, which undoubtedly broadens our view of strategy research in transition economies in general (e.g. Meyer and Peng, 2005; Wright et al., 2005).

5 Managing the Firm-Government Relations in China: A Political Strategy Perspective

5.1 Introduction

Governments' control of resources and opportunities shapes business and its institutional environment (e.g. Baron, 1995; Ring et al., 2005). In practice, strategizing the firm-government relationship is a challenge (e.g. Watkins, 2003), especially for foreign firms that operate in transition economies, where they face weakly enforced institutions (e.g. Caves, 1996; Makino et al., 2004; Peng, 2003; Roland, 2000). China is a unique case. The gradual approach to economic transition there has led to the development of a hybrid market system where government intervention remains substantial (Nee, 1992). Similarly, as a result of decentralization, local governments also intervene in local economic activities. Behaving as agents of the central government and at the same time as entrepreneurs themselves, *local governments* represent a major source of uncertainty for foreign firms. This chapter investigates why and how foreign firms strategically manage their relationship with local government in China.

Previous research confirms that host governments have gradually shifted from an adversarial to a cooperative attitude towards foreign firms (Dunning, 1998; Vernon, 1998). Traditional international business scholarship usually sees the relationship between foreign firms and host governments as conflicting and adversarial (Fagre and Wells, 1982; Kobrin, 1987), and entailing negotiations between two parties on entry, operations and exit (Ramamurti, 2001). Responding to the change in government attitudes in many parts of China, foreign firms have adapted to local economic demands and the local institutional context (Luo, 2001b). These studies contribute to our understanding of the relationship between foreign firms and host governments, but fall short of explaining how foreign firms politically engage host governments to *influence* the institutional environment.

Recently, a *political strategy perspective* has been developed which provides insights into this question (e.g. Baron, 1995; Bonardi and Keim, 2005; Hillman and

Hitt, 1999). Acknowledging the significance of non-market factors for firms, political strategists argue that firms need to develop means to influence government and public policy decisions, thus to reduce uncertainty (Bonardi and Keim, 2005; Rugman, 1998). From the political strategy perspective, firms develop either a transactional or a relational approach to reach their goals (Henisz and Zelner, 2004; Hillman and Hitt, 1999). This approach is supported by various strategic actions; either reactive (e.g. Boddewyn and Brewer 1994), or proactive (Hillman and Hitt, 1999). Therefore, foreign firms not only react to but also act upon the institutional environment by strategizing their relationship with host governments. Despite this acknowledgement of the political behavior of foreign firms (Boddewyn and Brewer, 1994) however, academic knowledge of the political strategies of foreign firms remains scant (Hillman and Wan, 2005). Few studies on the political strategies of multinational corporations (MNCs) have begun to model the relationship between host government and firms' subsidiaries as the level of analysis (Blumentritt and Nigh, 2002; Hillman and Wan, 2005): they analyze the *national* government as the counterpart of foreign firms instead of examining the particular role of *local* governments – this, according to academics of transition economies (in particular China), is an unsatisfactory approach (e.g. Krug, 2004; Walder 1995). In addition, the assumption of democracy in a developed economy is not applicable to China. Meanwhile, omitting the specificity of a firm's context when examining its political behaviour is certainly unhelpful (Brasher and Lowery, 2006; Peng 2002; Rodriguez et al., 2006). Few studies have so far been conducted on the political strategies of firms in the context of China (Kennedy, 2007; Li and Zhou, 2005).

This chapter employs insights from the political strategy perspective to analyze the relationship between foreign *subsidiaries* and *local* governments. We studied 24 foreign firms in China in order to understand their political behaviour in this particular political context. Our study demonstrates that the specificity of the context plays a significant role in shaping the political strategies of foreign firms. Based on our field work in China, we claim that foreign subsidiaries are geared to mitigating bureaucratic burdens and appropriating rents in their relations with local governments, rather than trying to influence public policy at the central-government level. Successful firms need to combine technical capabilities (size and technology) with social capital (*guanxi*) to effectively operate in China.

While previous empirical studies on political strategies have focused on strategic actions, this study contributes to the theory of political strategy by linking incentives with both strategic actions and organizational choices (i.e. relations with the government). Strategic actions and organizational forms do not necessarily follow in sequence (Hillman and Hitt, 1999), but are more likely interdependent. This study

expands the political strategy approach by exploring how strategic actions and organizational forms affect the non-market performance (rents in the political market) of firms in a non-democratic economy. In addition, this study enriches our understanding of the political behaviour of foreign firms by adding a local perspective (Gets, 1997). Not only does the behaviour of local governments shape the different demands of foreign firms in the local political market, but informal institutions substantially constrain their political behaviour too. The results of our study suggest that MNCs need to explore multiple layers of governance while focusing on two main relationships: one with central government, the other with local government. Therefore, our study has insightful implications for international business and (political) strategy research on transition economies (Shenkar, 2004; Wright et al., 2005).

The remainder of this chapter is organized as follows. Section 5.2 provides a theoretical framework for studying the political behaviour of foreign firms, followed by an outline of our research methods and case studies (Section 5.3). Section 5.4 presents our findings and is followed in Section 5.5 by a discussion and our contribution to extant theories, presented as a set of propositions. Section 5.6 concludes the chapter.

5.2 Theoretical Background

In this chapter, we attempt to explore why and how foreign firms seek to manage their relations with local governments in China. From the perspective of political strategy, firms need to integrate their political and market strategies in order to perform well (Baron, 1995). Analogous with economic markets, it is assumed that a political market exists where firms “demand” policies and (local) governments “supply” them (Bonardi et al., 2005). It is further assumed that firms in the same competitive environment will perform differently depending on their ability to deal with the non-market environment. Figure 5.1 shows a framework for studying the political behaviour of foreign firms, pointing to three major components, i.e. the non-market environment, firms’ individual characteristics, and the political behaviour of firms. These three components are explained in what follows.

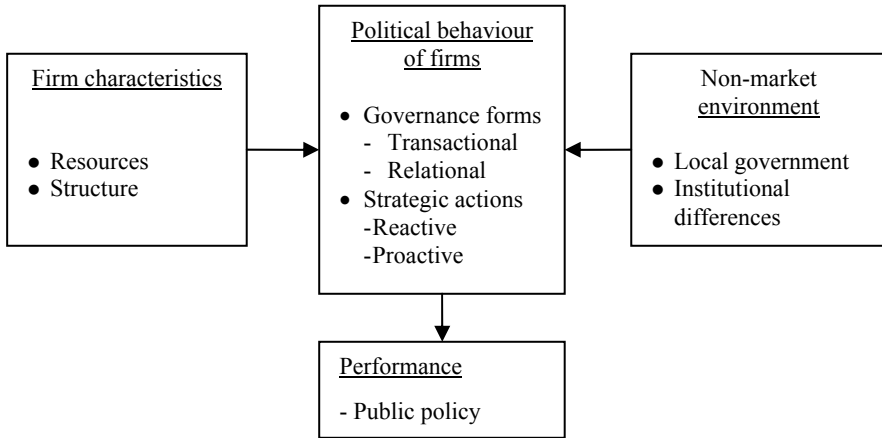


Figure 5.1 Design for the political strategies of foreign firms

5.2.1 Government and the Non-Market Environment

The successful political engagement of governments by firms is arguably fundamental to their survival and the implementation of their market strategies (e.g. Baron, 1995; Oliver, 1997). Government is the key supplier in this political market. Studies on political strategies demonstrate that government matters to firms in various ways (e.g. Bonardi and Keim, 2005; Bonardi et al., 2005; Gets, 1997; Schuler et al., 2002; Shaffer and Hillman, 2000). For example, government determines the rules of economic activity, the structure and scope of markets, and the provision of policies and services. In addition, these rules may be corrupted by government agents or officials (e.g. Rodriguez et al., 2005). For example, firms may fear a particularly unfavorable public policy or regulation that is being implemented (Gets, 1997; Shaffer, 1995), especially when salient issues are involved (Bonardi and Keim, 2005). This interdependence with the political environment (Casciolo and Piskorski, 2005; Pfeffer and Salancik, 1978) makes it attractive for firms to seek ways to influence government and public policy decisions to their advantage (Bonardi et al., 2006; McWilliams et al., 2002).

When expanding abroad, firms face political uncertainty caused by the institutional idiosyncrasies of the host country (Henisz, 2003) and therefore attempt to safeguard their operation by engaging the host-country government (Boddewyn and Brewer, 1994; Rugman, 1998). It is particularly important in transition economies where governments not only exert considerable influence over firms, but

frequently change their policies as well (Khanna et al., 2005; Ramamurti, 2003). This is, in China, characterized with weakly enforced hybrid economic institutions (Nee, 1992) and policy ambiguity (e.g. Child and Tse, 2001; EIU, 2003; OECD, 2005). Foreign firms have to seek ways to address the political uncertainty generated by these features (Daniels et al., 1985), while exploiting new opportunities in the public policy process (e.g. Qian, 2002).

The political uncertainty faced by foreign firms in China is directly linked to the local level, as decentralization empowers local governments to interpret and implement central policies according to their local conditions (Montinola et al., 1996; Segal and Thun, 2001). As a consequence, foreign firms face uncertainty not only caused by unexpected policy changes over time, but also directly generated by local governments as they establish their autonomy (e.g. Krug and Hendrischke, 2005). Therefore, it is expected that foreign firms are more likely to engage in political activities at the local level.

5.2.2 Firm Characteristics

A firm's characteristics (resources, structure etc.) shape its willingness and ability to engage in political strategizing (Getz, 1997). Organizational resources are identified in various measurements, such as organizational slack (Rehbein and Schuler, 1995), size (Fligstein, 1996; Schuler et al., 2002), technological level and the occurrence (and quantity) of economic spillover (Blumentritt, 2003; Hillman and Wan, 2005). *Organizational structure* refers to a formally established office to follow political changes in the host country and lobby for favorable policy enforcement (Rehbein and Schuler, 1995).

Previous empirical studies argue that organizational slack has a positive effect on the ability of a firm to engage in political strategizing, but its effect on the willingness of a firm to do so is indeterminate. Taking firm size as a proxy for organizational resources, it is argued that larger firms are likely to suffer more from political uncertainty and thus have a greater demand (willingness) for favorable public policies. In addition, larger firms are likely to have more resources (ability) to commit to political engagement.

Technology and *economic spillover* are important resources for foreign firms and offer leverage in political negotiations. Technology refers to the degree to which firms are technologically advanced. Economic spillover refers to the degree to which firms generate additional economic activity in the locality (in supply chains, for instance). The higher the degree of technological advancement or economic spillover, the more powerful the firm is in its interaction with the host government.

Empirical studies also show that the establishment of a formal department to manage political strategies is positively related to the willingness and ability of a firm to engage in political activities (e.g. Rehbein and Schuler, 1995). A firm with an established governmental affairs office often has high demand for political actions, and specialists staffed in the office make the firm adept at political activities.

5.2.3 The Political Behaviour of Firms

As shown in Figure 5.1, both the political environment and the characteristics of a firm influence its political behavior. We identify two aspects of the political behaviour of firms, i.e. governance forms and strategic actions. As in the literature on supply or contractual relations, two distinct governance forms, transactional or relational, can be distinguished (Boddeyn and Brewer, 1994; Henisz and Williamson, 1999; Henisz and Zelner, 2004; Hillman and Hitt, 1999). The transactional form refers to a short-term, discrete exchange between firms and government. The relational form refers to a long-term, close and re-negotiable agreement between partners. As has been argued elsewhere (e.g. Krug and Pólos, 2004; Luo, 2006), the choice between these two forms is influenced by the political uncertainty in transition economies where (foreign) firms “internalize” uncertainty by choosing a relational form which facilitates quick adjustments to changing circumstances and engagement with the institutional environment.

The choice between transactional or relational forms may also be shaped by the behaviour of the host government. Drawing on institutional theory (DiMaggio and Powell, 1983; Scott, 2001), Hillman and Hitt (1999) argue that countries that emphasize personal relations and collective decision-making will opt for a relational form; in contrast, more individualistic or legally pluralistic countries opt for a transactional form. Studies on China agree that network capitalism (Boisot and Child, 1988, 1996), if not local corporatism (e.g. Nee, 1992; Oi, 1995; Walder, 1995), is the best term to describe the institutional environment there. It can therefore be expected that foreign firms will follow the example of domestic firms in China (Bruton et al., 2000; Che and Qian, 1998; Li and Zhou, 2005) and also opt for a relational form to manage the relationship with local government and to mitigate political hazards.

In addition, firms will choose between reactive and proactive actions (e.g. Boddeyn and Brewer, 1994; Hillman and Hitt, 1999). Reactive actions include compliance, avoidance, and circumvention. Boddeyn and Brewer (1994) argue that, in confrontation with the host government, foreign firms may comply with imposed requirements by the government, avoid them by leaving the country, or circumvent

them through informal activities. Proactive actions include an information strategy (lobbying, for example), an incentive strategy (contributions to politicians, for example), and a “constituency” strategy (public relations etc.). When adopting a reactive approach, firms give up opportunities to bargain for better policies. Therefore, Hillman and Hitt (1999) argue that firms are more likely to take proactive measures in order to profit in the political market. Empirical studies have shown that firms are more proactive than reactive with respect to their political behaviour and when attempting to *shape* public policy outcomes in their interests (e.g. Bonardi et al., 2006). In transition economies (and especially in China), proactivity enables firms to leverage government support (e.g. Li and Zhou, 2005; Peng and Luo, 2000; Sanyal and Guvenli, 2000), which is crucial for mitigating the political transaction costs created in an uncertain institutional environment. Established firms, often incurring substantial sunk costs, are therefore often highly network-concerned in their dealings with government (e.g. Hendrischke, 2007; Li, 2005) and tend to use voice (proactive action) instead of exit (reactive action) when engaging government (Zhu et al., 2006). Previous studies in an international setting show that the ability of a firm (determined by a firm’s characteristics) positively impacts on its commitment to each of the three proactive actions (Blumentritt, 2003; Hillman and Wan, 2005; Schuler et al., 2002). Therefore, it is expected that foreign firms in China are more likely to take proactive action when they have the higher ability to do so.

To summarize, the political strategy perspective suggests that political engagement leads to potential rents that can be appropriated using a fitting strategy in the political market. In order to capture these rents, foreign firms have to manage their governmental relations strategically. The political behaviour of foreign firms is thus reflected in their preferred governance forms and choices of strategic action directed at local government. Preferred governance forms are moderated by political uncertainty and the structure of the political system. The choice of strategic actions is determined by the willingness and ability of a firm to politically engage. In what follows, we develop a case study to investigate the political strategies of foreign firms at the local level and the applicability of our proposed framework.

5.3 Research Method

5.3.1 Case Study

In this study, we are concerned with the political behaviour of foreign firms in China. Therefore, as described above, we are interested in motivation, governance and strategic action; and to what extent political behaviour is influenced by the non-market environment and firms' characteristics. We studied 24 foreign firms in five cities from 2004 to 2006. Table 5.1 presents the characteristics of the cases studied. Our cases are diverse in terms of size, sector, country of origin, and year of establishment - this permits a cross-case analysis. Twelve cases are large in size in terms of employment or investment capital, while the other twelve cases are either small or medium-sized. All 24 cases operate in 14 industries at a 3-digit code level. Thirteen of the cases are involved in production using advanced technology. In addition, eleven cases are financed by western investors, while the remaining thirteen are financed by Asian investors (including one from the Virgin Islands). All of our cases are foreign firms established in the period from 1992 to 2005, roughly matching the period after 1990 in which 90% of foreign firms were established. The characteristics of our cases do not affect our analysis since we are not attempting to provide a representative survey, but rather exploring new insights from a particular kind of experience (Child, 2002).

5.3.2 Data Analysis

We follow a synthetic strategy (Langley, 1999) to analyze the case data, constructing the political behavior of foreign firms in China, using an iterative process of analysis (Uzzi, 1996; Yin, 2003). From the raw interview data (transcripts), we first generated a series of minicases by synthesizing these with archival data (Eisenhardt, 1989), which provided narratives of the political behaviour of the foreign firms we studied. Second, we individually coded "events" (such as uncertainty, the ability of firms, governance forms, and strategic actions) and variables that described them according to the proposed framework. Third, following the method of analytic induction (Cressey, 1953; Yan and Gray, 1994), we started with one case study, the findings of which were reviewed to confirm, or reject the proposed behavioural pattern. Our theoretical model is modified in view of the findings. This comparison was repeated for all cases, leading to an insightful framework for the analysis of the Chinese context. This iterative analysis improved the fit of our model and the reliability of our findings, which are described in what follows.

Table 5.1 Characteristics of foreign firms studied (to be continued)

Case No.	Origin	Location	Year of establishment	Ownership mode	Number employed	Investment capital (million USD)	Industry	Status of technology
1	Taiwan	Dezhou	1993	WFOE	1200	60	Textile	Low
2	South Korea	Dezhou	1994	JV	100	1.4	Electronic devices	Medium
3	Austria	Dezhou	1999	JV	70	12	Non-mental mineral materials	Low
4	Singapore	Wuxi	2004	WFOE	750	81	Electronic devices	High
5	Netherlands	Suzhou	1994	JV	2000	110	Household Electronics	High
6	Singapore	Suzhou	1995	WFOE	900	30	Tools	Medium
7	Virgin Island	Suzhou	1996	JV	5300	0.9	Garden design	-
8	USA	Suzhou	1997	WFOE	60	5	Tools	High
9	UK	Suzhou	1997	WFOE	70	135	Pharmaceuticals	High
10	Taiwan	Suzhou	1999	WFOE	1500	20	Office equipment	High
11	Taiwan	Suzhou	2001	WFOE	3150	100	Electronic devices	High
12	Taiwan	Suzhou	2001	WFOE	500	34.5	Auto parts	Low
13	Taiwan	Suzhou	2001	WFOE	2500	30	Tools	Medium
14	South Korea	Suzhou	2003	WFOE	500	4	Electronic devices	High
15	Taiwan	Suzhou	2005	WFOE	700	36.6	Electronic devices	High
16	Japan	Hangzhou	1992	WFOE	2000	21.4	Electronic devices	High
17	Hong Kong	Hangzhou	1993	JV	200	-	Garments	Low

Table 5.1 Characteristics of foreign firms studied (continued)

Case No.	Origin	Location	Year of establishment	Ownership mode	Number employed	Investment capital (million USD)	Industry	Status of technology
18	France	Hangzhou	1994	JV	110	7.8	Software	High
19	France	Hangzhou	1999	JV	50	0.2	Household products	Low
20	USA	Hangzhou	2001	WFOE	60	-	Garden design	-
21	USA	Hangzhou	2002	WFOE	70	12	Electronic devices	High
22	USA	Hangzhou	2003	JV	35	3	Electronic devices	High
23	USA	Hangzhou	2003	JV	2000	340	Communications equipment	High
24	Netherlands	Shanghai	1998	WFOE	17	-	Banking	-

Note: Size is measured by the number of employees and the size of investment capital. Small refers to foreign firms with no more than 100 employees or investment capital of less than five million USD. Medium refers to foreign firms with between 100 and 500 employees and/or investment capital between 5 and 10 million USD. Large refers to foreign firms with more than 500 employees and/or investment capital greater than 10 million USD.

5.4 The Political Behaviour of Foreign Firms in China

Through cross-case analysis, we develop a context-based understanding of the political behaviour of foreign firms in China seeking to manage their relations with local government, most likely motivated by incentives at the local level. The choice of governance forms and strategic actions is interlinked, and determined by both the behaviour of local governments and the organizational resources of firms.

5.4.1 “Rent-seeking” Chinese Style

All cases show that foreign firms indeed engage in political behaviour, which is directed at local rather than central government. At the local level, the political uncertainty that foreign firms face is generated by the (ambiguous) behaviour of local government and weak institutions (as summarized in Table 5.2). Therefore, the main motivation of foreign firms in the political market is to seek rents (i.e. to mitigate government intervention and capture preferential treatment) favourable to a stable local environment, and consequently, to secure their operation in a dynamic, transitional market.

Table 5.2 Uncertainty at local level

Uncertainty issues	Evidence from cases
– Official intervention (by various bureaus) at the local level	4, 8, 9, 13, 17, 19, 24.
– Unpredictable policy change (e.g. labour policy, city regulation, electricity usage regulation) at the local level	3, 10, 11, 12, 16, 17, 18, 19, 20, 21, 22, 23.
– Ambiguous policy implementation (e.g. land usage rights, labour union policies, import quotas, intellectual property rights, taxation, credit) at the local level	1, 2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 14, 15, 16, 18, 21.

First of all, our cases show that foreign firms face political uncertainty related to *official intervention* at the local level, as evidenced in seven cases (see Table 5.2). Such interventions may come from various government bureaus. Firms can not avoid interacting with local government because, amongst other reasons, doing business here often requires licenses, permits etc. For example, the tax offices may come to inspect a firm’s financial situation without notice (cases 4, 13, and 19); the fire prevention office may impose additional requirements on the firm (cases 4, 8 and 9), as may the public security bureau (cases 9 and 17). In addition, foreign firms

may be challenged by local regulatory bodies. The informant in Case 24 stated that “The government is very bureaucratic... The local regulator frequently comes to visit us and offers advice on business issues. We must show respect for this kind of behaviour. Otherwise, we may lose our certificate of operation”.

It must be noted that these interventions occur not only formally, where the government may have the well-being of society in mind; but also informally (unofficially) and with uncertain legitimacy. This point is illustrated in particular in Case 9:

Case 9: “One day, an officer from the fire prevention bureau came to check our facilities and subsequently required that we upgrade them. He recommended a shop where we could purchase the needed materials. The firm took this officer seriously and the general manager asked for another meeting. Through the meeting, we found that the person used a ‘black business card’¹ upon which there was only his name and telephone number. It implied that the person did not necessarily conduct the investigation on behalf of his office. However, we could not directly dismantle his disguise because we did not know for sure whether he was acting in his own interests or otherwise. Therefore, we had to approach the local government in order to settle this issue.”

The second source of political uncertainty at the local level is unpredictable *policy changes*, as evidenced in twelve cases (see Table 5.2). For instance, Case 3 reported a situation where new city regulations created a serious problem for the firm:

“For a period, the city government attempted to regulate the running of trucks in urban areas. All trucks carrying raw materials, such as sand, could not enter or pass through urban areas during the day time. Sand is the major raw material we need for production. In order to safeguard our regular operation, we reported to the Administrative Committee of the Development Zone who could help us to negotiate with the city government for a solution.”

In addition, eight foreign firms (cases 16, 17, 18, 19, 20, 21, 22 and 23) operating in the same city reported another situation where they all faced the problem of electricity shortages and related government regulations. Accordingly, during times of peak usage in the summer, the electricity supply of factories was cut off for 3 days every week. These firms were concerned about the financial loss caused by this regulation and therefore sought to get special arrangements, such as a reduction of the number of days “off”, or the provision of a guaranteed electricity supply.

Cases 10, 11 and 12 encountered problems caused by local labour policy changes. Frequent changes in policy impose additional costs on firms. For example, an increasing bottom-line salary for labour leads to higher production costs; while newly established compensation rules for injured labour not only have a cost effect, but even put foreign firms at a disadvantage. The informant in Case 11 very explicitly stated that “the new policy required that a firm should pay an employee a few months’ salary as compensation if the employee proposes ending the labour contract after an on-site injury. Such a policy is in accord with that in developed countries, but not necessarily in accord with the local conditions. An employee could take advantage of this policy. As a result, it impedes the operation of firms”.

The third source of political uncertainty is *ambiguous policy implementation* at the local level, as evidenced in sixteen cases (see Table 5.2). In China, as a consequence of decentralization, the implementation of central policies is often manipulated by local governments. The informant in Case 10 stated that “very often, the local government implements the central policies in the way that meets their interests”. Such fuzzy policy implementation motivates foreign firms to seek rents through political engagement on various issues. For example, firms may seek ways to receive more tax holidays (cases 11 and 15), land at a discounted price (cases 7, 18 and 21), quicker service in the bureaucratic process (cases 4, 5, 6, 10, 14, and 21), or the mobilization of capital inputs (case 2).

In addition, cases 9 and 16 reported a problem regarding labour union policy. According to the law in China, all firms (domestic and foreign) should have an established labour union. However, these two firms were not happy with this policy and negotiated a solution. Cases 1 and 8 were dissatisfied with their import quotas of raw materials, which were assigned by sub-national governments. The informant in Case 1 mentioned that “in the first few years, we did not get a quota. Without the guaranteed input, it was hard for us to get orders from customers. Therefore, we approached the local government for help”. Case 9 pointed to the sensitive issue of dealing with pirated products: “Although the central government has made efforts to protect intellectual property right, those pirates are often under the umbrella of local authorities in the location where they operate. In order to fight against product pirates, we have to get along with the local government”. Another four cases (cases 10, 11, 14 and 15) reported problems regarding the refunding of duty on imported duty-free parts. The quote from Case 14 is illustrative:

Case 14: “When the firm imports parts for export-oriented production, those parts are duty-free. When products are exported, the local customs office checks and compares the volumes of imports and exports. If the difference between these two volumes is

beyond a certain range, the firm has to pay duties for the parts that are not used for exported products and gets a fine. Not only is the deviation range based on approximation, but the size of fine is also not specified clearly. The actual size is decided by officials' discretion, which is in a range of 1 to 20 times of due duties. In order to get a smaller fine, we have to rely on the local government to negotiate with the local customs office."

In sum, as cases 4 and 5 demonstrate, capturing political rents is very necessary in China in order to facilitate smooth firm operations because laws and policies are often imperfect in definition and implementation. Our findings confirm the necessity for engagement of the political market (Bonardi et al., 2005; Boddewyn and Brewer, 1994) at the local level in China. Our findings are in line with the results of previous studies such as Blumentritt (2003) and Shaffer (1995) that firms are all willing to work the institutional environment to their advantage. However, at the local level, foreign firms do not politically engage to influence the enforcement of public policy per se (e.g. Bonardi et al., 2006), but more to seek rents from policy implementation at the local level, which help to mitigate government intervention and secure preferential treatment regarding various business issues. This reflects common international observations on China's economic transition (e.g. OECD, 2005).

5.4.2 Choosing the Relationship with Local Government

Our cases demonstrate that local government is the key stakeholder in the local environment, and therefore, a cooperative relationship with local government is necessary to smooth the bureaucratic process and capture political rents. For instance, the informant in Case 1 states that "During the operation, the firm develops an interactive relationship with the local government. Once a good relationship is established, the firm can always go for help when it encounters problems". This statement implies the utility of long-term interactions with the local government in China. Case 2 makes it even clearer by saying that "A cooperative relationship with the local government can help the firm to make sufficient and best use of policies". Therefore, a relational form is preferred over a transactional one by foreign firms to manage the relationship with local government, which allows them to re-negotiate political risks and mitigate the transaction costs involved in doing business in China (e.g. Krug, 2004; Nee, 1992).

Our cross-case analysis shows that the selected relational form is structured at both macro and micro levels (as shown in Table 5.3). The macro level refers to statutory relations between firms as organization and the local government in which

official activities take place. The micro level refers to informal relations in which social activities take place between firm managers and officials. At the macro level, the relational form may be regarded as a partnership or collaboration, which is observed in 21 cases. For instance, the informant in Case 5 commented that “The relationship between us and the local government is a kind of partnership. It is maintained by continuous interactions”. This is echoed by the statement of one official interviewed: “The relationship between the government and firms is a collaborative one. The government does not attempt to intervene with firms’ operation. Firms may experience some conflicts with functional bureaus. We try to help them to solve problems”. At the micro level, the relational form is manifested in guanxi networks, which are maintained in all 24 cases. The informants admitted that guanxi networks of managers with key officials (such as directors, or the party secretary of a development zone or city, directors of governmental bureaus, and so on), grow out of continuous business contacts. Often, guanxi networks prevail in the interaction with local government. As reported in Case 18, “guanxi is embedded in the society and the way business is done, and therefore, it is not realistic to try to avoid it”. Guanxi networks open opportunities for negotiation and re-negotiation, and often supplement, or even substitute formal institutional support (e.g. Xin and Pearce, 1996).

Table 5.3 The relationship between foreign firms and local government

	Macro level	Micro level
Relational form	Collaboration/Partnership (21 cases)	Guanxi networks (24 cases)
Government actions	<ul style="list-style-type: none"> – Official visits to firms – Official invitations to firms to participate in decision making (e.g. regular consultation on policy issues) – Official invitations to firms to take part in public projects or social activities (e.g. New Year celebration) 	<ul style="list-style-type: none"> – Dining/wining with firm managers – Personal requests for gifts or favours (e.g. arranging jobs or seeking business opportunities for relatives)
Firm actions	<ul style="list-style-type: none"> – Respect for the government – Cooperation with the government by providing information on decision making – Official donations to public projects 	<ul style="list-style-type: none"> – “Wining and dining” with officials – Favour-giving by, for example, offering jobs and business opportunities to officials’ relatives

Our findings show that the relational form is shaped by the behaviour of both government and firms. At the macro level, collaboration is established on the basis of interdependence. Local governments expect tax revenues and technology transfers from foreign firms, while foreign firms expect a stable business environment. Interactions take place frequently between the local government and foreign firms. Local government, behaving as a local corporatist, intends to have a close relationship with foreign firms. For example, the local government (or officials) often make formal visits, or bring visitors to firms (such as in cases 1, 5, 8, 9, 16, 17, 18 and 24), organize regular meetings with foreign firms to consult on their policy concerns or encountered problems (such as in cases 5, 9, 10, 11, 12, 13, 14, 15 and 23), or invite firms to take part in public projects (e.g. donations) or officially organized social activities such as New Year celebrations (such as in cases 4, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 19, 23). As a response, foreign firms “need to show respect to the government (or officials) by actively participating in the activities organized by the government” (Case 12). For instance, firms often have to spend extra time and effort in receiving visits from the government. When financial contributions are needed, foreign firms tend to negotiate a solution. When doing so, it is very important that “the firm should not make officials lose face”. The quotes from cases 8 and 16 are revealing:

Case 8: *“A good relationship with the local government is based on reciprocity. The firm expects a positive payoff. Therefore, the firm should not confront the government but try to establish a basis for mutual communication”.*

Case 16: *“We sometime face the request for sponsorship of activities organized by the government. We do not reject it but may negotiate the actual size of the contribution because rejecting a request would be regarded as a bad behaviour. Cooperation further contributes to the development of a positive and sustainable relationship, which eventually benefits our operation.”*

Our findings demonstrate that local government pays more attention to large firms and high-tech firms, regarding them as crucial players in the development of the local economy, implying that large firms and/or high-tech firms are more easily engaged in collaboration. The following quotes are revealing:

Case 1: *“The firm’s size makes the firm stand out as one of the largest firms in the location. The government regards it as a representative foreign firm, i.e. window firm, of the location. Very often, the government organizes visits to the firm.”*

Case 23: *“We attract the attention of the government by our brand name and our use of advanced technology. We are often invited by the government for meetings to talk about our concerns and policy issues. There are more than 1000 hi-tech firms in the zone, and only about 20 are often invited. The government selects firms based on their scale, technological advancement, and other factors.”*

At the micro level, guanxi networks are established and maintained through “wining and dining” and the exchange of favours between managers and officials, as evidenced in all cases. While foreign firms are all engaged in guanxi networks, they are also well aware of the cost of maintaining them. Therefore, they become cautious about being too close in these personal connections. The embedded costs of guanxi networks are those related to spending time on socialising and, more importantly, those related to giving favours. Very often, these requests are hard to meet from the perspective of a firm manager, especially when these requests come frequently. This cost-concern creates a paradox for foreign firms in managing guanxi networks (see the following quote from Case 4). Therefore, firm managers attempt to maintain “some distance in guanxi networks” (the informant in Case 9).

Case 4: *“There are both benefits and costs of maintaining guanxi with officials. The firm wishes to grow through guanxi networks and attract attention from the government. But, the more the firm grows, the more attention it receives from the government. This growing attention may lead to more requirements from the government officials such as donations to different kinds of projects organized by the government and favours to their own or relatives’ business”.*

In sum, our findings on the choices made by foreign firms regarding the relationship with local government are in line with the argument that the relational form is positively linked to political uncertainty (Henisz and Zelner, 2004) and to the interest of government in acquiring the participation of firms in the policy domain (Hillman and Hitt, 1999). However, the findings in our study go further by suggesting that the relational form needs to be structured at both the macro and micro level. This shows that foreign firms are often network-concerned when doing business in China (e.g. Hendrischke, 2007; Li, 2005) and that they attempt to use the personal connections of managers (guanxi) to support the organization-level relationship with the government (Peng and Luo, 2000). Distance-awareness in guanxi connections provides empirical evidence for the strength of business-government networks (Peng and Zhou, 2005). Guanxi networks, as a form of governance, are nothing new to studies on China (Krug, 2004; Yang, 1994), but

continue to call for scholarly attention to social embeddedness (Granovetter, 1985) and local politics (Gets, 1997). To focus purely on the formal institutional setting, as in previous studies, is certainly not sufficient (e.g. Xin and Pearce, 1996).

5.4.3 Choosing Strategic Actions

Our theoretical framework suggests that foreign firms may take reactive or proactive strategic action in the political market. Table 5.4 summarizes the strategic choices of foreign firms. Our cases allow us to identify four strategic actions: compliance, information, incentive and “constituency”. The cross-case analysis shows that foreign firms regard proactive actions as an appropriate means to seek rents in the political market, but proactive actions do not necessarily exclude reactive compliance strategies. Through compliance, foreign firms show respect for local government, developing a base from which they may proactively engage. No evidence was found on avoidance and circumvention actions. The findings show that all 24 firms used information and incentive strategies, but only nine out of 24 cases used a “constituency” strategy. These actions are context-related. The choice of proactive actions is described below in detail.

The cross-case analysis shows that foreign firms actively take up opportunities to provide information regarding problems they encounter (bureaucratic inefficiency, for instance) and policy concerns in order to influence government policy implementation (information strategy). Foreign firms often make use of five tactics when sharing information (e.g. policy concerns and operation problems). All firms combined both office visits and social activities as an opportunity to draw the attention of key officials to their interests. As the informant in Case 5 stated, “we have to “wine and dine” officials, which plays an important role in facilitating communication and information exchange”. In fourteen cases, the managers channelled their policy concerns to the government at officially organized social meetings (such as New Year and mid-Autumn moon festival celebrations). In addition, cases 14 and 18 used telephone calls as another method for sharing information. Cases 2 and 14 provided written reports when tackling policy issues concerned. The informant in Case 14 mentioned that “after passing on the message by making telephone conversation, it is better to provide a written report that can provide the information regarding the issue concerned in detail”.

Table 5.4 Strategic actions by foreign firms in the local environment

Strategic actions	Tactics	Evidence from cases
Compliance	– Respects for officials and policies	All
Information	– Office visits	All
	– “Wining and dining”	All
	– Officially organized meetings (e.g. festival celebration)	3, 4, 5, 8, 9, 10, 11, 12, 14, 17, 18, 19, 20, 23
	– Telephone calls	14, 18
	– Written reports	2, 14
Incentive	– Contributions to the local economy (taxes, tech-transfers etc)	4, 5, 6, 8, 9, 11, 12, 13, 14, 15, 16, 17, 18, 20, 21, 22, 23
	– Support for government bureaus (e.g. customs, road construction, electricity, fire prevention) and officially organized activities	1, 2, 4, 7, 9, 11, 15, 16, 21
	– Favours or gifts to officials	4, 5, 8, 23
“Constituency”	– Donations (e.g. for people suffering from natural disasters)	1, 2, 5, 14, 15, 18
	– Sponsorship of public activities	1, 17
	– Social services (e.g. the funding of public services and amenities)	5, 11
	– University scholarships	16

Foreign firms also influence governments by offering them incentives to cooperate (incentive strategy). The most often used tactic here is to make a contribution to the local economy (in addition to that created by normal operations) – a tactic employed by seventeen firms. According to the informants, a contribution to the local economy could be, for example, an expressed commitment to transfer technological know-how. The second tactic of the incentive strategy was to offer support to governmental bureaus directly, which was evidenced in nine cases. For instance, Case 2 contributed 300,000 RMB to improve the electricity supply to the area where the firm operates, and also invested in road construction in collaboration with the local government. In Case 4, the firm, together with other foreign firms, bought one advanced fire truck for the local fire prevention office in order to

forestall its intervention. In Case 15, the firm voluntarily participated in a pilot project organized by the local customs office to test service procedures, with the expectation that they would receive better bureaucratic service in the future. In a further six cases (1, 7, 9, 11, 16 and 21), the firms provided financial sponsorship to various activities organized by government bureaus, such as a trade fair. The third tactic of the incentive strategy was to give favours (such as gifts, paid travel, and aid to officials' relatives) to officials personally, as evidenced in four cases (4, 5, 8, and 23). The informant in Case 8 stated that, "giving favours to officials is a very useful means for the firm to get preferential treatments as a return".

Foreign firms can not mobilize voters to develop their constituency, so to influence the government in China, because there is only very limited democracy. Nevertheless, our findings do show that foreign firms engaged a "constituency" strategy in four ways. The tactics used include making public donations (cases 1, 2, 5, 14, 15 and 18), providing sponsorship for public activities, for example, an international basketball match (Case 1) and a garment design competition in a university (Case 17), organizing public services, such as public parks and an orphanage (cases 5 and 11), and establishing university scholarships (Case 16). In this way, foreign firms attempted to establish a positive reputation and good standing in the locality, thus capturing the attention of the local government.

In sum, our findings point to the significance of proactive engagement for influencing the government, a finding that is in line with Hillman and Hitt (1999) and Hillman and Wan (2005). However, it appears that foreign firms do also comply with government policies in certain aspects, as Blumentritt (2003) and Boddewyn and Brewer (1994) would suggest. Blumentritt (2003) assumes that reactive and proactive actions may take place simultaneously depending on the issues involved. Our findings further suggest that foreign firms may leverage their reactions for success in their proactive engagements. In China, indeed, firms do not really want to bear the sunk costs caused by exit (reactive action) when dealing with the local government, but tend to leverage exit for voice (proactive action) in re-negotiation for preferential treatment (Zhu et al., 2006). In addition, the tactics used by foreign firms in their strategic actions in China differ somewhat from those used in developed economies (Hillman and Hitt, 1999). This difference suggests that the Chinese situation (and that of other transition economies) needs to be better integrated into the study of the political strategies of foreign firms.

5.4.4 The Relationship between Performance and Political Behaviour

Foreign firms in our study confirm that overall firm performance is dependent upon their choosing appropriate political strategies, which in turn reflects what rents foreign firms gain in the local political market. Our study allows for the identification of three facets of political performance (as summarized in Table 5.5): mitigation of government intervention (such as in cases 4, 8, 9, 13, 17, 19, 24), achievement of special treatment (in eighteen out of 22 firms that encountered policy issues), and no gain in pursuit of special treatments (as in cases 7, 17, 19 and 20). Four major determinants of performance emerge, which are firm size, reputation in technology, economic spillover, and social capital (referring to only *guanxi* here).

All seven firms, having succeeded in mitigating interventions, reported that they have social capital available. In the event of government intervention, foreign firms contacted key officials on the administrative committee of the development zone, explaining what had happened to them - mainly during office visits or informal meetings elsewhere. This information strategy draws the key officials into the solution-building process. In addition, firms regarded their size (in cases 4, 9, 13), their high status in technology and large contribution to local workplace and supply chains (economic spillover) (in cases 4, 8, 9, 13) as additional performance determinants. The factors of size, technology and economic spillover enabled them to develop a good relationship with the government and officials, which in turn became a very effective channel for the exchange of information. In addition, foreign firms leveraged their contribution to the local economy to influence the government. In order to settle an issue, foreign firms demonstrated their respect for government bureaus or officials (compliance) before becoming proactive. For instance, when the firm in Case 9 was required by a staff-member from the fire prevention bureau to upgrade their fire prevention facilities, the general manager promised to take action, consulting the staff on the one hand, and reporting to the administrative committee of the zone on the other. Although the firm in Case 9 did not want to upgrade their facilities, the solution was a compromise where the firm agreed to upgrade part of their facilities, thus saving the face of the fire prevention office.

Table 5.5 *Performance determinants of political behaviour*

Performance (Evidence from cases)	Determinants (Evidence from cases)	Relationship with local government	Strategic actions
Mitigation of interventions by government bureaux (4, 8, 9, 13, 17, 19, 24)	- Firm size (4, 9, 13) - Technology (4, 8, 9, 13) - Economic spillovers (4, 8, 9, 13) - Social capital(4, 8, 9, 13, 17, 19, 24)	- Relational form	- Compliance - Information - Incentive
Achievement of special treatments (such as more tax holidays) (1, 2, 3, 4, 5, 6, 8, 9, 10, 11, 12, 14, 15, 16, 18, 21, 22, 23)	- Firm size (1, 4, 6, 9, 10, 11, 12, 15, 16, 23) - Technology (4, 5, 8, 9, 10, 11, 12, 14, 15, 16, 18, 21, 22, 23) - Economic spillovers (1, 2, 3, 4, 5, 6, 8, 9, 10, 11, 12, 14, 15, 16, 18, 23) - Social capital(1, 2, 3, 4, 5, 6, 8, 9, 10, 11, 12, 14, 15, 16, 18, 21, 22, 23)	- Relational form	- Compliance - Information - Incentive
No gain regarding special treatments (7, 17, 19, 20)	- Firm size (17, 19, 20) - Technology (7, 17, 19, 20) - Economic spillovers (7, 19, 20)	- Relational form	- Compliance - Information - Incentive

The same determinants were found in the pursuit of special treatment. Factors such as firm size, technology and economic spillover empowered foreign firms when they negotiated with the local government. Social capital effectively facilitates the exchange of information between foreign firms and key officials. As a result, eighteen of the foreign firms studied here were successfully granted special treatment. For instance, the firms in cases 9 and 16 did not establish labour unions after negotiating with the local government. In Case 11, the firm received more tax holidays, as evidenced in the quote:

“...The more the firm is attracted to the local government, the more easily the firm can get help in solving problems. For example, our five-year tax holiday has passed. The firm attempted to apply for the certificate of advanced technology enterprise in order to get more special treatments. The tax office did not agree to further tax holidays. The reason was that, in order to receive the special treatments associated with advanced technology enterprises, the firm should have applied for the certificate when it was established instead of after 6 years. Therefore, the general manger visited the key officials in the administrative committee of the zone for help. The local government thinks it possible to find a solution and is helping to coordinate with the tax office”.

Our cross-case analysis shows that social capital is one crucial factor for nurturing a cooperative relationship with local government and for facilitating information exchange. The quotes from cases 8 and 24 are illustrative:

Case 8: *“Whether a firm encounters serious problems in operation, i.e. those issues related to the institutional environment, depends on what kind of people the firm employs. If the right person is employed to do the right thing, the problems will be much less”.*

Case 24: *“Considering the political uncertainty, we hired a local general manger, which is unusual in our corporation. The advantage is that he has good local guanxi and knows how to approach the government”.*

Furthermore, interviews with officials confirm, from the government’s side, that once foreign firms conflict with government bureaus, they tend to use their guanxi with key officials in an attempt to influence the outcome. One official further pointed out that “Those Asian firms, in particular from Hong Kong and Taiwan, tend to negotiate on policy issues more often through guanxi networks than Western firms do”. This said, our cross-case analysis did not identify a difference between Asian and Western firms. One reason is probably that the firms we interviewed all

have local general managers or deputy general managers who are dealing with the local government.

Nevertheless, as the informant in Case 18 commented, “the *guanxi* factor is crucial but not decisive in negotiations on special treatments. Instead, the economic contribution of a firm has a better say therein”. This is echoed by the informant in Case 9 who observed “the government provided us with special treatments because we made significant contribution to the local economy in terms of our size, technology, and economic performance”. The failures in cases 7, 17, 19 and 20 inadvertently support this point, stating that, due to the fact that they are of small size and/or not large local taxpayers, they did not win land (Case 7) or receive the requested supply of electricity (cases 17, 19 and 20). Underlying this point, the informant in Case 20 said, “facing an electricity shortage problem, we can not get the same special treatments as those large or high-tech firms do.”

In addition, our findings show that a relational governance form is almost always helpful, leading to sound performance in the political market and further reveal that information and incentive strategies are most effective when supplemented by compliance. In contrast, the “constituency” strategy does not have a direct effect on performance. The interaction between compliance and proactive engagement has not been examined in previous studies (e.g. Hillman and Hitt, 1999; Boddewyn and Brewer, 1994). Across all cases, it appears that technical resources and social capital have different effects on the choice of proactive actions. This is discussed later.

To summarize, Figure 5.2 provides an overview of our findings and our modifications to the theoretical framework. Our cross-case analysis shows that the willingness of foreign firms to politically engage is most likely related to the opportunity for rent-seeking (mitigation of interventions, preferential treatments etc.) in the local political market. This confirms that political activism occurs when there are potential benefits to be reaped in the political market (e.g. Bonardi et al., 2005) and extends the previous analysis by going beyond the examination of public policy enforcement at the national level (e.g. Hillman and Hitt, 1999; Rugman, 1998). Our study draws attention to fiscal decentralization and weakly enforced institutions (e.g. ambiguous policy implementation and arbitrary bureaucratic processes) in China’s transition.

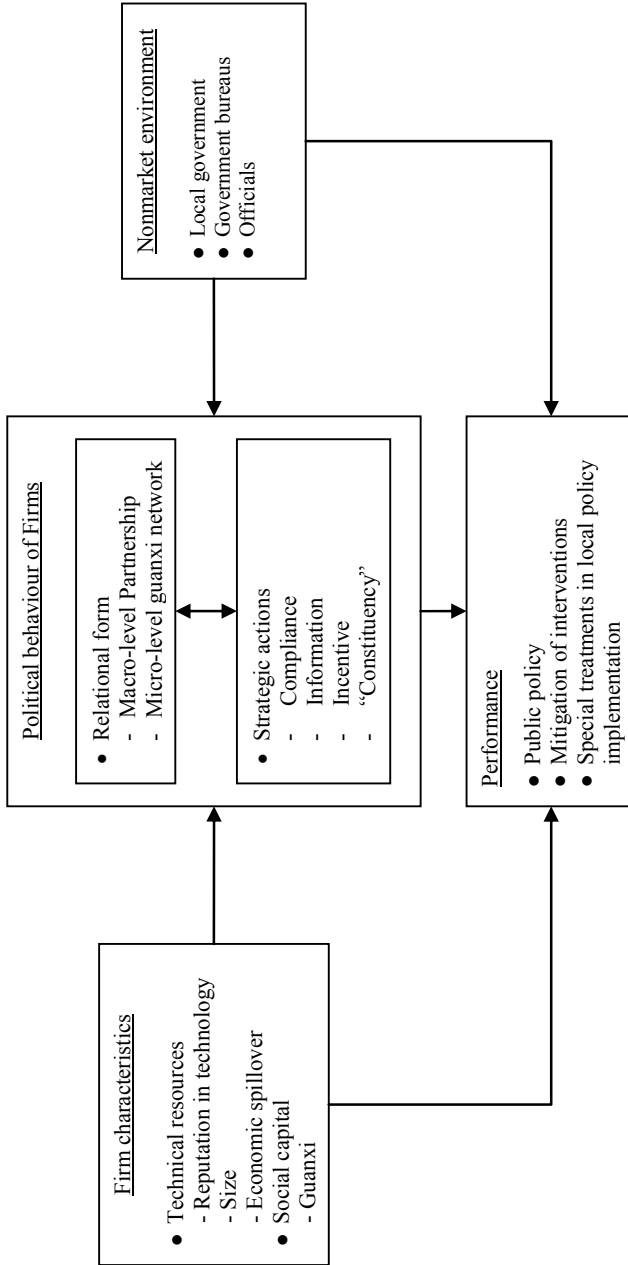


Figure 5.2 The political behaviour of foreign firms in local China

Further, the performance of foreign firms in the local political market is determined by their ability to politically engage, which is positively related to a firm's resources (e.g. Bonardi et al., 2006; Rehbein and Schuler, 1995). Our findings do not provide evidence of organizational slack (Rehbein and Schuler, 1995), but rather emphasizes technological factors. Since the beginning of reform, China has stressed the significance of introducing, learning and absorbing advanced technologies from developed countries. Therefore, foreign firms that invest with advanced technologies often earn a good reputation, enabling them to successfully leverage government support. We do not find the evidence of organizational structure either (Rehbein and Schuler, 1995). The foreign firms we interviewed do not have a public relation office for dealing with government. Instead, they mostly rely on managers and their *guanxi* to do so, since foreign firms are either small or often just a production unit of their parent corporation. Thus, we propose that social capital (*guanxi*) is an additional resource of the firm, a finding that is in line with other China-based management studies (e.g. Peng and Luo, 2000; Tsang, 1998), which point to the importance of "having *guanxi*" when doing business there.

Finally, the political behaviour of foreign firms needs to be captured in both organizational form and action. Our findings suggest that the form of contact between foreign firms and local government, in which they engage in long term cooperation, may best be described as relational (e.g. Dunning, 1998). This relationship is shaped and maintained by the interactions of both parties at both the macro and micro levels. From a firm's point of view, such interactions are determined by both technical resources (technology, size, economic spillover etc.) and social capital (Luo, 2001b). Therefore, it is suggested that the strategic decision of foreign firms may follow their choice of relationship with local government, as proposed by Hillman and Hitt (1999), and may further reinforce the relational form initially selected.

5.5 Discussions and Propositions

Our cases demonstrate that the political strategy perspective is insightful for the understanding of the foreign firm-host government relationship. Previous studies on the political strategies of foreign firms have focused on cross-country analysis in which the national government of a host country is modelled (e.g. Blumentritt and Nigh, 2002; Hillman and Wan, 2005). This approach is arguably useful when foreign firms operate in a developed economy where economic institutions are well enforced and local governments have limited authority over economic activity. Our

investigation adds a local perspective, emphasizing the significance of local government in China.

As shown in Figure 5.2, local government, together with its bureaucracies, is the appropriate counterpart for the analysis of foreign firms. As a consequence of de facto fiscal decentralization, local governments are granted sufficient authority to interpret and implement central policies and thus to intervene in local economic activity (e.g. Li, 1997; Qian, 2002; Segal and Thun, 2001; Walder, 1995). Our study therefore suggests that, considering the significance of sub-national institutions in China (Meyer and Ngyuen, 2005; Osland & Björkman, 1998), MNCs may have to manage their host-government relations at two levels: national and local. Detailed analysis of layered governance goes beyond the scope of this study. In this chapter, we have focused on the localized interactions between foreign firms and local government. This perspective fruitfully contributes to our understanding of international political strategies (e.g. Gets, 1997; Rodriguez et al., 2006). In the following, we bring our findings and recent theoretical development together to put forward some tentative propositions.

5.5.1 Political Rent-Seeking at the Local Level

Our findings highlight the different incentives underlying the political behaviour of foreign firms at the local level in China. They suggest that the particularity of the institutional context in China (or in transition economies in general) must play a role in formulating the political objectives of foreign firms (e.g. Brasher and Lowery, 2006; London and Hart, 2004). Previous studies argue that firms aim to influence public policies to manage political uncertainty (e.g. Bonardi and Keim, 2005; Frynas et al., 2006). It is assumed that public policy is the major source of uncertainty firms have to face in their operations. This assumption works well in developed economies (such as the US and the EU), where firms can rely on strong enforcement mechanisms in the public policy domain. However, as Hillman and Wan (2005) argue, the study of host-country institutions is especially important in developing economies and the analysis of these needs to be set in the specific context of the host country.

Entering China, firms have to manage both institutional complexity (Henisz, 2003) and institutional voids (Khanna et al., 2005; OECD, 2005). Our findings confirm that foreign firms in China not only face policy ambiguity but also various interventions that may effectively hinder their operations, both of which are major sources of uncertainty threatening business, according to the enterprise survey of the World Bank (2005). These problems can best be seen at the local level, because it is

local governments who interpret and implement central policies and often have enough leeway to design their own industrial policy (e.g. Krug, 2004; Segal and Thun, 2001). In this process, government bureaus and officials may have different interests from the government itself, creating agent problems. Our findings evidence that uncertainty at the local level is caused by bureaucratic interventions, unpredictable policy changes, and ambiguous policy implementation. Problems at the local level may hinder a firm's operation (e.g. in Case 1 and 3) and may also impose additional costs (as occurred in cases 8, 9, 11 and 15). In addition, leveraging local policy implementation brings additional benefits (cases 5, 16 and 23). Therefore, foreign firms have a strong interest in rent-seeking in the local political market. It is proposed that:

Proposition 1.1: Foreign firms act politically when they encounter interventions from local government bureaus.

Proposition 1.2: Foreign firms act politically when they have the opportunity to appropriate rents from local policy implementation.

5.5.2 Determinants of Political Performance

Our findings identify determinants of the actual political performance of foreign firms in China. While previous studies have attempted to explain the determinants of political behaviour (e.g. Blumentritt and Nigh, 2002; Boddewyn and Brewer, 1994; Hillman and Hitt, 1999), "little analysis has directly examined the determinants of actual performance" (Bonardi et al., 2006). Bonardi et al. (2006) suggests that the experience of firms in dealing with government policy makers and the opportunity for them to learn from others are positively related to performance. However, our findings point to both technical resources (size, technology, and economic spillover) *and* social capital (guanxi) as determinants. In China, social capital embodied in guanxi networks plays an important role in managing the external relations of a firm (e.g. Peng and Luo, 2000). When managers engage in guanxi networks with officials, their firms have the opportunity to learn from officials and to gain easy access to their experience and knowledge. Therefore, social capital may be an equivalent to experience and opportunity in Bonardi's argument. Yet, social capital alone is not decisive, as evidenced in our cases, especially when foreign firms negotiate for preferential treatment. Social capital is better, or more decisively employed to cope with bureaucratic interventions. The technical resources of a firm often determine to what extent the firm gains from local policy implementation. For instance, when eight firms (cases 16, 17, 18, 19, 20, 21, 22 and 23) encountered an electricity

shortage problem, all possessed social capital and sufficiently communicated their concerns (information) to the city government. However, only five firms, which had either invested with advanced technology or had mobilized significant levels of local resources (workplace and supply chains) received preferential treatment, i.e. they secured either less cut-off days or a guaranteed electricity supply for their operation. In so doing, the local government expects a higher return from firms of this kind for the local economy. Therefore, firms with more technical resources are more likely to appropriate rents successfully from their cooperation with local government (e.g. Luo, 2001b). Therefore, it is proposed that:

Proposition 2.1: The higher the technology level a foreign firm invests, the more leverage the firm has in its relations with local government.

Proposition 2.2: The more a foreign firm can mobilize local resources, the more leverage the firm has in its relations with local government.

Proposition 2.3: Social capital has a positive effect on the outcome of political activities: the effect is stronger when it comes to resisting interventions than to appropriating rents.

5.5.3 Relations with Local Government

Our findings suggest that foreign firms tend to choose a relational form when approaching government in China, a finding that, while in line with Luo (2001b), provides additional evidence at the local level. This choice suggests that local governments may best be described as local corporatists (Hillman and Hitt, 1999) in that they actively promote certain sectors or opt to cooperate with certain firms by supplying production factors, mobilizing all agencies and bureaus and designing specific industrial policies (Oi, 1992; Walder, 1995). In addition, China's transitional environment is often represented as a highly uncertain and/or unregulated one (Nee, 1992) in which local governments have sufficient authority to manipulate the local environment (Che, 2000; Frye and Shleifer 1997). Our findings demonstrate that foreign firms positively respond to the behaviour of local governments, while a relational form serves as an effective approach for 'internalizing' uncertainty (e.g. Henisz and Zelner, 2004; Hillman and Hitt, 1999).

Our findings further point out that the relationship between foreign firms and local government is structured at both the macro and micro levels. Previous studies of both political strategies and political governance only emphasize the macro-level (Henisz and Zelner, 2004; Hillman and Hitt, 1999). As it is argued by sociologists, a formal relationship is often embedded in social networks (Granovetter, 1985; Uzzi,

1996). In particular, in transition economies such as China where formal institutions are weak, social networks play a significant complementary role in governance (e.g. Krug, 2004; Xin and Pearce, 1996). Previous studies on MNCs in China also confirm that guanxi networks with government officials are crucial for them to safeguard against uncertainty (e.g. Frynas et al., 2006; Osland and Björkman, 1998; Sanyal and Guventi, 2000). As our cases demonstrate, guanxi networks provide foreign firms with political leverage and strategic resources (Peng and Luo, 2000; Yeung, 2000) to encourage the cooperation of the government. Therefore, it is proposed that:

Proposition 3.1: When local government is cooperative, foreign firms choose to reciprocate.

Proposition 3.2: When local government agencies are not cooperative, guanxi is seen as a way to encourage their cooperation.

5.5.4 Strategic Actions and Determinants

Our findings highlight four strategic actions that foreign firms adopt to influence local government, i.e. compliance, information, incentive, and “constituency” strategies. Previous empirical studies have focused on the last three proactive actions, sorting out their determinants such as firm size, technology, and economic spillover (e.g. Blumentritt, 2003; Brasher and Lowery, 2006; Schuler et al., 2002). Our study not only confirms the effect of firm size, technology and economic spillover, but further suggests social capital (guanxi) as an additional determinant of strategic action.

While previous studies argue that technical resources (size, technology and economic spillovers) have a positive effect on the three proactive actions, our findings do not find a link to the “constituency” strategy and further demonstrate differentiated effects of the determinants. First, our findings show that social capital is the most crucial factor influencing the information strategy. Guanxi networks enable a firm to channel information quickly and effectively to officials, no matter how many technical resources the firm possesses. Guanxi with key officials therefore generates higher returns on an information strategy. Secondly, reputation in technology is singled out as the most crucial factor in an incentive strategy. Similarly, as our cases show, foreign firms provide additional incentives to the local government by making a demonstrable commitment to the locality and mobilizing local resources as well. Corporate reputation is one crucial resource of value creations, which is measured along multiple dimensions, reflecting the perceptions

of external stakeholders and interested groups (e.g. Roberts and Dowling, 2002; Wartick, 2002). In particular, a reputation for advanced technology makes a foreign firm very attractive to local government and creates the possibility of greater rents (favourable treatments), since local government continues to urgently seeks the transfer of advanced technology to upgrade local industries.

Furthermore, little analysis has been done on compliance. Boddewyn and Brewer (1994) propose that a firm may comply with the government when the issue involved is not of crucial importance to a firm, or if a firm lacks the resources to influence government. To the contrary, our findings show that foreign firms regard compliance as a means of supplementing proactive engagement. Through compliance, foreign firms show respect for government and a willingness to cooperate, which builds confidence and establishes a sound basis for further negotiation. Therefore, compliance and proactive engagement are not mutually exclusive. Compliance does not mean that the issues involved are not salient or that a firm lacks resources. Rather, compliance is more a demonstration of a firm's positive attitude to local government.

In sum, it is proposed that:

Proposition 4.1: The stronger the guanxi a foreign firm has, the higher the returns on an information strategy.

Proposition 4.2: The higher the reputation a foreign firm has, the higher the returns on an incentive strategy.

Proposition 4.3: Compliance and proactive strategies are not mutually exclusive, and foreign firms may pursue both.

5.6 Conclusion

This chapter examines why and how foreign firms manage their relations with local government from a political strategy perspective. Our findings show that foreign firms are motivated to mitigate interventions and capture more regulatory rents. To do so, foreign firms choose a relational form to manage their relationships with local government, both with macro-level partnership and micro-level guanxi networks. In addition, foreign firms widely adopt proactive engagement (in particular information and incentive strategies) to influence local government decision-making. Meanwhile, compliance supplements, and facilitates, smooth proactive engagement. Our findings also show that both technical resources and social capital empower foreign firms in the political market. Our study contributes to the understanding of the

relationship between foreign firms and host governments by identifying the strategic incentives and actions that underpin the relationship at the local level (e.g. Boddewyn and Brewer, 1994; Luo, 2001b).

Thus, our findings contribute to the general understanding of the political strategy approach by adding a local perspective (e.g. Getz, 1997). All politics is indeed local and this perspective identifies the appropriate behaviours leading to fruitful outcomes (rents) in the political market. Our findings suggest that contextualization is insightful for both international business and political strategizing (e.g. Brasher and Lowery, 2006; Jones, 2006; Wright et al., 2005). Therefore, context-based strategies must be examined when a survey study is conducted in an international setting. In particular, when analyzing the effect of informal institutions, it is not sufficient to consider only an abstract concept of culture (Wan and Hillman, 2006). Rather, it is insightful to consider *guanxi* (and social networks in general) and its connection with weakly enforced formal institutions. In practice, our findings suggest that foreign firms must “think local” (Park and Vanhonacker, 2007) and need to have a sensitivity to the local political context and respect for local government when formulating strategy. It is perhaps difficult for foreigners to engage *guanxi* networks in China and our findings suggest that employing and relying on local management (localization) is an effective way to neutralize this difficulty.

In addition, the political strategy perspective extends our understanding of the strategic orientations of firms in the formation of managerial networks in China (e.g. Li, 2005; Peng and Luo, 2000). While previous studies argue that firms are driven by market and technological factors in the formation of managerial networks, our study adds that (foreign) firms also seek to capture political rents (beyond market information) in the formation of managerial networks. Political rents at the local level in China arguably allow foreign firms to achieve their strategic objectives in a developing market environment (Baron, 1995).

We are however cautious about generalizing, though, the diversity of our cases provides strong support for our findings. These extend previous studies of political strategy and subsequently allow for the formulation of tentative propositions for future tests. Furthermore, our study points to a number of worthwhile research avenues. First, it would be interesting to develop a comparative study examining whether Asian firms (in particular those from Hong Kong and Taiwan) have an advantage over Western firms in their familiarity with and experience of *guanxi* networks. Second, it would be interesting to study the collective political behaviour of foreign firms in a development zone. Third, a future investigation could examine

the relationship between social responsibility and a “constituency” strategy to assess the effect of such activities on the political performance of foreign firms in China.

Notes

- 1 A black business card is a card that does not indicate the association of the person who uses it, but contains only the person’s name and telephone number.

6 Conclusion

From an institution-based perspective, the interaction between institutions and organizations is central to the strategic decision-making of foreign firms in China's transition economy. To answer the question of how an institution's context matters to strategy, we conducted three empirical studies in this dissertation. This chapter concludes our dissertation by presenting a summary of our main findings and theoretical contributions, and suggesting future research avenues.

6.1 Summary and Contributions

This dissertation has addressed three theoretical issues in international business strategy, namely: 1) the dynamics of isomorphism in foreign ownership; 2) a process approach to ownership choice; and 3) management of the firm-government relationship. The first issue was investigated using a panel database of foreign firms in China from the period 1979 to 2003. The other two issues were explored through the use of case studies from six cities in China. Here, we summarize our main findings in three points:

1. *An institution-based view* is insightful for understanding the strategies of foreign firms in transition economies such as China. Institutions, both formal and informal, have a direct effect on the strategizing of foreign firms. For example, the ownership choices of foreign firms reflect both efficiency and legitimacy concerns. In particular, the business behaviour of foreign firms is conditioned by the political behaviour of government. Foreign firms need to manage their nonmarket environment effectively in order to successfully pursue their market strategies.
2. *A learning process* takes place, which informs the strategic decisions of foreign firms in China. Foreign firms need to be able to sense subtle changes in laws and policies and to acquire knowledge about local institutions (including informal ones) by direct interactions when they make strategic

decisions. A learning process makes smooth adaptation possible. To do so, foreign firms need to build on their learning capabilities.

3. *A local perspective* is therefore needed to analyze institutional effects. In China, the institutional environment is heterogeneous, presenting diversity at the local level. Here, formal institutions interact with informal ones, determining the features of the local institutional environment, where foreign firms usually operate. Therefore, the local perspective is crucial for the operationalization of strategy by focusing on the specific conditions foreign firms have to deal with locally.

Chapter 3 investigated how the dynamics of organizational homogeneity in ownership decisions are related to institutional liberalization, as well as the strategic considerations of firms. Our findings show that the degree of organizational isomorphism decreases as foreign ownership constraints become deregulated and the level of local acceptance of foreign ownership increases. These findings confirm that institutional changes may weaken established isomorphism (Oliver, 1992; Powell, 1991; Scott, 2001). Another finding is that the degree of organizational isomorphism decreases as conventional wisdom (cognitive force) regarding appropriate ownership forms changes. While previous studies address cognitive forces in a static way, our finding points to its dynamic features (Li et al., 2007). This implies that the effect of cognitive forces on (the dynamics of) isomorphism may be more complicated than published empirical conclusions suggest. In addition, our findings in Chapter 3 show that the dynamics of organizational homogeneity also reflect shifts in the strategic considerations of foreign firms, which tended to enter the market through joint ventures and followed a learning strategy in the early years of reform, but shifted over time to WFOE form, following a control strategy. More importantly, the findings in this chapter support the complementarity hypothesis: both market and institutional factors matter in explaining organizational changes (e.g. D'Aunno et al., 2000; Kraatz and Zajac, 1996); each factor has a reinforcing effect on the other and both inform the explanation of the dynamics of isomorphism in ownership decisions.

Chapter 4 analyzed how foreign firms engage in the interaction with local institutions when deciding their ownership mode. The findings of our cross-case analysis demonstrate that observed ownership choices often differ from what firms desired to have prior to entry (Gomes-Casseres, 1990). This supports the hypothesis of a two-phase learning process: identifying preferences, then adjusting to local conditions, and illustrates that the ownership choices are not simply made at headquarters (preference), but are subject to changes *in situ* when directly confronted by local institutions. Although foreign investors do consider possible

constraints when identifying their ownership preferences, on-site adjustment is still necessary due to information asymmetry at the local level. Previous studies based on a variance approach do not (and are perhaps unable to) explain this ownership adjustment. Our proposed learning process synergizes three different theoretical perspectives (transaction costs, organizational capabilities, and institutional theory) so to create a phased decision-making model in which local solutions are developed. This learning process helps to clarify the inconsistent empirical findings in previous studies and further draws scholarly attention to the importance of local institutions (local government and local business societies). Our findings suggest that a process approach to understanding internationalization is not only useful, but is also line with recent developments in the field (e.g. Meyer and Gelbuda, 2006; Tallman and Shenkar, 1994). While adding a local perspective complicates the process, it adds value to our understanding of the ownership choices of foreign firms and of international strategies in general (Meyer and Nguyen, 2005).

Chapter 5 examined why and how foreign firms manage their relationships with local governments in China. Our findings point to the particularity of the nonmarket environment in China, the uncertainty generated by the policy ambiguity and arbitrary behaviour of local governments and the necessity for engagement of the nonmarket environment at the local level in China (e.g. Bonardi et al., 2005). Therefore, foreign firms are motivated to politically engage in order to minimize or avoid local interventions, to capture preferential treatment and ultimately to safeguard their operations at the local level. The local perspective once again enriches our understanding of international political strategies (e.g. Rodriguez et al., 2006). Our findings show that the performance of foreign subsidiaries in the local political market is determined by both technical *and* social resources (e.g. Frynas et al., 2006). In their political behavior, foreign subsidiaries establish a relational governance form, blending macro-level partnership with micro-level *guanxi* networks, to mitigate transaction costs. The macro-micro link proves to be an effective form for firms seeking to manage their local relations (Peng and Luo, 2000). In order to maintain their relationships and mitigate political uncertainty, foreign subsidiaries adopt proactive strategies, such as information and incentive strategy. This is often supplemented by a reactive attitude to compliance, which extends the views of Hillman and Hitt (1999) on proactive action. The findings in this chapter suggest that, in order to better manage the relationship with local governments, foreign firms have to effectively deploy their technical capabilities and build up social capital at the local level in China.

Overall, this dissertation has demonstrated that institutions play a crucial role in the strategizing of foreign firms in China, providing additional dimensions to the calculation of their strategies. This dissertation is a positive response to the calls for attention from scholars of institutions in international business and strategy research. This is especially the case when studies are conducted on transition economies (Child and Tse, 2001; Meyer and Peng, 2005; Shenkar, 2004; Wright et al., 2005). In addition, our case-based exploration generates insightful propositions regarding the interaction between institutions and organizations, which we believe contributes to the extant body of knowledge. Our insights are China-specific, but they may be fruitfully applied to other transition economies.

6.2 Future Research Directions

This dissertation has outlined the significance of institutions in the strategizing of foreign firms in China. From here, the most obvious step, drawing on propositions advanced in Chapter 4 and Chapter 5, would be to develop a survey for more systematic testing. The case-based approach establishes sound propositions, but in order to generalize them, large-scale empirical tests are required. In addition, the insights in the dissertation point to several avenues along which valuable research may be conducted.

An institution-based view proves to be beneficial to the body of knowledge about global strategies (Peng, 2005). The interaction between formal and informal institutions is very much context-embedded. Scholars suggest that, facing the institutional complexity of a country such as China, foreign firms face a tension between internal and external legitimacy (Kostova and Zaheer, 1999; Xu and Shenkar, 2002), often choosing either to adapt to local conditions or to maintain their own familiar mode of operation (Boisot and Child, 1999). Our findings on ownership choices show that foreign firms tend to manage the tension in a hybrid way, i.e. developing a tradeoff between internal and external legitimacy, which is in line with a recent exploration on IJVs (Lu and Xu, 2006). Therefore, we call for further research of other organizational dimensions, such as human resource management (HRM) practices, to explore the effect of institutions on foreign firms' HRM choices and social responsibility practices. As localization is often emphasized as the most important trend in the management practices of foreign firms (e.g. Lu and Bjorkman, 1997), another avenue would be to explore the dynamics of localization in response to institutional change.

The interaction between foreign firms and local institutions in China may be characterized as a learning process. While previous studies on this issue mainly focus on the transfer of knowledge from headquarters to their subsidiaries, recent studies have begun to pay attention to the reality of headquarters learning from their subsidiaries (e.g. Ambos et al., 2006), which highlights the merit of subsidiaries to their parent networks and the advantages in acquiring local knowledge (Rugman and Verbeke, 2001). Therefore, a further avenue of future research could be to look into what knowledge, and by which mechanisms, foreign headquarters learn from their operations at the local level in China; to explore whether (and to what extent) knowledge acquired from a specific location can be applied to other locations; and to establish how knowledge sharing across subsidiaries in different locations takes place. Embarking on a conventional approach (exploitation and exploration) to learning (March, 1991), another research avenue may be to investigate what rules and knowledge foreign firms explore and what they exploit at the local level.

A local perspective draws our attention to local institutions within China. Only recently have international business scholars paid much attention to local (or sub-national) institutions in transition economies (e.g. Meyer and Nguyen, 2005). While our findings illustrate the effect of local institutions on foreign firms' organizational choices, what needs to be further studied is how the presence and operation of foreign firms influences institutional building at the local level in China. It is argued that decentralization and fiscal federalism lead to diversity in the institutional environment at the local level and give rise to a variety of local business systems (Krug and Hendrischke, 2005). It would be interesting to examine what foreign firms have contributed to the formulation of local business systems, and to examine the interaction between foreign firms and local supply chains.

With the above insights in mind, we identify the study of the coevolution of foreign firms in China as yet another worthwhile avenue of future research. Our study of the dynamics of isomorphism in this dissertation has implied that foreign firms evolve in their ownership choices in response to institutional changes in China. Recent studies on network strategies in transition economies propose that network strength evolves as institutional transition proceeds (Peng and Zhou, 2005). Recent theoretical developments regarding multinationals suggest that a coevolutionary perspective has direct implications for competitive advantages when we examine the performance of foreign firms (e.g. Madhok and Liu, 2006). From a coevolutionary perspective, foreign subsidiaries co-evolve not only with the local environment but also with their parent corporations. The speed differential of these two levels may impact a firm's overall performance. Embarking on different theoretical perspectives, our dissertation offers insights into the coevolution of foreign subsidiaries, but needs

to be extended to consider the coevolution of foreign firms within their own corporate webs. Given the increasing significance of China to the world economy, it is essential that MNCs and foreign subsidiaries view China as a core component of their global strategy. Moreover and inevitably, they must learn to leverage China through their operations and strategies (Boston Consulting Group, 2006). Therefore, a coevolutionary perspective would enrich our understanding of the success of foreign firms and our understanding of the emerging rules of global business that China is helping to write.

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Samenvatting

(Summary in Dutch)

Deze dissertatie is een antwoord op de belangstelling voor instituties in zowel strategieonderzoek als in onderzoek naar internationaal zakendoen in China en andere opkomende economieën (Child en Tse, 2001; Narayanan en Fahey, 2005; Shenkar, 2004; Tseng en Foster, 2006; Wright et al., 2005). Het groeiende belang van opkomende economieën zoals China komt tot uitdrukking in de toename van onderzoek op dit gebied in de twee genoemde richtingen gedurende de afgelopen jaren. Onderzoekers betogen dat, aan de ene kant, “er behoefte bestaat om na te denken over in hoeverre theorieën en methodologieën die gebruikt worden om strategieën te onderzoeken in volwassen, ontwikkelde economieën geschikt zijn voor de unieke sociale, politieke en economische contexten” (Wright et al., 2005). Aan de andere kant, aandacht besteden aan ondernemingen die opereren in zulk een unieke context biedt de mogelijkheid om belangrijke bijdragen te leveren aan de bestaande kennis op dit gebied (Tsui et al., 2004).

Startend vanuit een institutie-gebaseerde zienswijze, richt deze dissertatie zich op de vraag in hoeverre instituties relevant zijn in de strategiebepaling door buitenlandse ondernemingen in China door te kijken naar drie theoretische vraagstukken, namelijk 1) de dynamiek van isomorfisme bij buitenlands eigendom; 2) een proces-benadering van eigendomskeuze; 3) het beheersen van de relatie tussen onderneming en overheid. Het eerste vraagstuk is onderzocht door gebruik te maken van een paneel database van buitenlandse ondernemingen van 1979 tot en met 2003. De overige twee vraagstukken zijn verkend door middel van gegevens uit “case studies” in zes steden in China. Deze dissertatie komt tot de volgende conclusies:

1. Een *institutie-gebaseerde invalshoek* is verhelderend bij het leren begrijpen van buitenlandse ondernemingen in overgangs-economieën zoals China. Instituties, zowel formele als informele, hebben een direct effect op de strategiebepaling van buitenlandse ondernemingen in China. Bijvoorbeeld: de keuze van eigendom door buitenlandse ondernemingen wordt zowel door efficiency als door legitimiteits-criteria bepaald. In het bijzonder wordt het

zakelijke gedrag van buitenlandse ondernemingen medebepaald door het politieke gedrag van de overheid. Buitenlandse ondernemingen dienen hun niet-zakelijke omgeving te beheersen om hun markt-strategieën uit te kunnen voeren.

2. Een *leerproces* vindt plaats in de strategiebepaling door buitenlandse ondernemingen in China. Buitenlandse ondernemingen moeten opmerkzaam zijn op subtiele veranderingen in wetgeving en beleid en zij dienen kennis te verwerven over lokale instituties (inclusief informele) door middel van directe interacties en gesprekken bij het nemen van strategische beslissingen. Een leerproces maakt geleidelijke aanpassing mogelijk. Om dit te bereiken dienen buitenlandse ondernemingen te vertrouwen op hun leervermogen.
3. Een *lokale invalshoek* is daarom nodig om institutionele effecten te analyseren. De institutionele omgeving in China is heterogeen met een grote verscheidenheid op lokaal niveau. Lokale overheden en lokale zaken-gemeenschappen spelen vaak een belangrijke rol in de interacties met buitenlandse ondernemingen. Op lokaal niveau treden formele instituties in wisselwerking met informele instituties en dit bepaalt de kenmerken van de institutionele omgeving. Buitenlandse ondernemingen opereren dus vaak in een institutionele omgeving met een lokaal karakter. Een lokale invalshoek heeft gevolgen voor de operationalisering van instituties in strategie-onderzoek, alsook voor diegenen die dit in de praktijk brengen door aandacht te besteden aan de specifieke omstandigheden waarmee zij op lokaal niveau dienen om te gaan.

Hoofdstuk 3 behandelt hoe de dynamiek van organisationele homogeniteit in beslissingen aangaande eigendom gerelateerd zijn aan institutionele liberalisatie, alsmede aan strategische overwegingen van ondernemingen die transitionele economieën zoals China betreden. De bevindingen tonen aan dat de mate van organisationeel isomorfisme afneemt wanneer beperkingen aan buitenlands bezit worden geliberaliseerd en wanneer de sociale acceptatie van buitenlands bezit toeneemt. Deze bevindingen bevestigen dat institutionele veranderingen gevestigde isomorfismen verzwakken (Oliver, 1992; Powell, 1991; Scott, 2001). Een andere bevinding is dat de mate van organisationeel isomorfisme afneemt wanneer de voor vanzelfsprekende aangenomen overtuigingen (cognitieve kracht) ten aanzien van de meest geëigende eigendomsvorm veranderen. Terwijl eerder onderzoek de cognitieve kracht op een statische wijze benaderden, benadrukt dit onderzoek de dynamische kenmerken (Li et al., 2007). Het gevolg van deze kenmerken is dat het effect van cognitieve krachten op (de dynamiek van) isomorfisme complexer is dan

empirisch is onderzocht in bestaande publicaties. De bevindingen in hoofdstuk 3 tonen tevens aan dat de dynamiek van organisationele homogeniteit in eigendomsbeslissingen een verschuiving van strategische overwegingen door buitenlandse ondernemingen uitdrukken. Zij neigen tot het aangaan van joint ventures met een leerstrategie tijdens de eerste jaren van de Hervorming, en transformeren in de loop der tijd naar WFOE met een beheers-strategie. Belangrijker is dat de bevindingen in dit hoofdstuk de complementaire hypothese ondersteunen: zowel markt- als institutionele factoren zijn relevant voor het uitleggen van organisationele veranderingen (bijv. D'Aunno et al., 2000; Kraatz en Zajac, 1996). Het combineren van beide redeneringen versterkt ieders effect en resulteert in een betere uitlegbaarheid van de dynamiek van isomorfisme in eigendoms-beslissingen.

Hoofdstuk 4 analyseert hoe buitenlandse ondernemingen omgaan met lokale instituties bij hun beslissingen ten aanzien van eigendomsvorm in China. De bevindingen die afgeleid worden uit cross-case analyse tonen aan dat de waargenomen eigendomskeuzes door buitenlandse ondernemingen vaak afwijken van de aanvankelijk door hen gewenste vorm (Gomes-Casseres, 1990). De bevindingen ondersteunen daarmee het tweefasige leerproces. Het tweefasige leerproces identificeert voorkeur en aanpassing als twee aparte fasen en toont aan dat de keuze van eigendomsvorm van buitenlandse ondernemingen niet alleen op het hoofdkantoor buiten China gemaakt wordt (voorkeur), maar ook onderhevig is aan aanpassingen ter plaatse wanneer men geconfronteerd wordt met de lokale instituties. Alhoewel buitenlandse investeerders mogelijke beperkingen door centraal beleid in aanmerking nemen bij de evaluatie van de meest gewenste eigendomsvorm, zijn bijstellingen ter plaatse nodig vanwege de informatie-asymmetrie op lokaal niveau. Eerdere studies die gebaseerd waren op de variantie-benadering waren niet in staat om de aanpassingen van eigendomsvorm te verklaren. Het voorgestelde leerproces verbindt de verschillende theoretische benaderingen (transactie-kosten, organisationele capaciteiten en institutionele theorie) en resulteert in een gefaseerd beslissingsmodel waarin lokale oplossingen worden ontwikkeld. Dit leerproces helpt aan de ene kant om inconsistente empirische bevindingen te verklaren, aan de andere kant nodigt het uit om ook wetenschappelijk aandacht te besteden aan lokale instituties (overheid en zaken-gemeenschap) in China wanneer de eigendomskeuzen van buitenlandse ondernemingen worden bestudeerd. De bevindingen in dit hoofdstuk bepleiten dat een proces-benadering veel inzichten verschaft voor het begrijpen van internationalisering, hetgeen in overeenstemming is met recente ontwikkelingen in het vakgebied (bijv. Meyer en Gelbuda, 2006; Tallman en Shenkar, 1994). Het toevoegen van een lokale benadering compliceert het proces, maar levert veel toegevoegde waarde voor het begrijpen van eigendomskeuzen door

buitenlandse ondernemingen en van internationale strategieën in het algemeen (Meyer and Nguyen, 2005).

Hoofdstuk 5 onderzoekt hoe buitenlandse ondernemingen omgaan met hun relaties met lokale overheden in China. De bevindingen wijzen in de richting van de verschillen in de niet-zakelijke omgeving tussen China en het Westen. In China wordt de onzekerheid in de niet-zakelijke omgeving in hogere mate veroorzaakt door de lokale overheid, hetgeen gepaard gaat met dubbelzinnigheid ten aanzien van beleid en willekeur van officiële kant. Het benadrukt ook de attractiviteit van de niet-zakelijke omgeving op lokaal niveau voor buitenlandse ondernemingen in China (bijv. Bonardi et al., 2005). De drijfveren voor buitenlandse ondernemingen om zich in te laten met politieke activiteiten in China zijn het voorkomen van lokale interventies en het verwerven van meer buitengewone behandelingen door lokale overheden, en uiteindelijk het veiligstellen van hun operaties op lokaal niveau. De lokale benadering van transitionele economieën verrijkt wederom ons begrip van internationale politieke strategieën (bijv. Rodriguez et al., 2006). De bevindingen tonen aan dat de prestaties van buitenlandse dochterondernemingen op de lokale politieke markt worden bepaald door zowel technische middelen als door het sociale kapitaal dat zij bezitten (bijv. Frynas et al., 2006). In hun politieke gedrag gebruiken buitenlandse dochterondernemingen een relatiegerichte bestuursvorm voor hun relaties met de lokale overheden, waarbij partnerschap op macroniveau gecombineerd wordt met 'guanxi' netwerken (gebaseerd op persoonlijke relaties) op microniveau, om zodoende de kosten van handelsovereenkomsten te beperken. De macro-micro-koppeling heeft aangetoond een effectieve vorm te zijn voor ondernemingen om hun externe relaties te beheersen (Peng and Luo, 2000). Om relaties in stand te houden en politieke onzekerheid te beperken doen buitenlandse dochterondernemingen proactieve strategische stappen, zoals het verschaffen van informatie en stimulansen, maar vaak wel met een afwachtende houding van volgzzaamheid als toevoeging, hetgeen een uitbreiding is van de zienswijze van Hillman and Hitt (1999) ten aanzien van proactieve acties. De bevindingen in dit hoofdstuk suggereren dat buitenlandse ondernemingen effectief gebruik moeten maken van hun technische mogelijkheden en sociaal 'kapitaal' moeten opbouwen op lokaal niveau, om zo hun relaties met de lokale overheden in China beter te beheersen.

Deze dissertatie toont aan dat instituties een beslissende rol spelen in de strategiebepaling van buitenlandse ondernemingen in China, daarbij een extra dimensie toevoegend aan de strategische besluitvorming. De bevindingen in deze dissertatie vormen een zeer positieve respons op de vraag naar wetenschappelijke aandacht voor instituties in het onderzoek naar internationaal zakendoen en strategie

(Child en Tse, 2001; Meyer en Peng, 2005; Shenkar, 2004; Wright et al., 2005). Daarnaast resulteerde de casus-gebaseerde verkenning in inzichten betreffende de wisselwerking tussen instituties en organisaties in de strategievorming van buitenlandse ondernemingen. Deze inzichten mogen dan specifiek zijn voor China voor wat betreft inhoud, we durven te stellen dat ze voor wat betreft structuur veralgemeend kunnen worden voor andere economieën.

中文摘要 (Summary in Chinese)

中国等转型经济国家的发展越来越引起国际商务和战略研究学者的重视。这些领域的学者都主张对制度因素给予特别关注（Child & Tse, 2001; Narayanan & Fahey, 2005; Shenkar, 2004; Tseng & Foster, 2006; Wright et al., 2005）。一方面，有必要对现有理论和研究方法的适用范围进行界定，即这些适用于发达国家的理论和方法在多大程度上也适用于转型经济的社会、政治和经济环境（Wright et al., 2005）；另一方面，对这种特定环境中的企业进行研究对于延伸现有的理论知识大有帮助（Tsui et al., 2004）。基于此，本论文从制度的视角出发，探讨制度是如何影响外资企业在中国的战略考虑。

本论文集集中研究了三个问题：外资所有权形式的同一性变迁、从过程视角看外资企业的所有权选择、以及外资企业——政府关系的治理。第一个问题的分析是基于 1979 年至 2003 年中国批准成立的外资企业的统计数据；其余两个问题的数据来源于我们在中国六个城市所做的案例研究。本论文的主要发现可以总结为以下三点：

1. 基于制度的视角对于理解外资企业在中国这样的转型经济国家的战略选择极富洞见力。正式制度和非正式制度对外资企业在中国的战略选择都有直接影响。例如，所有权形式的选择同时体现了效率原则和合法性原则；外资企业的商业行为受制于政府行为；为了更好地执行市场战略，外资企业需要有效地治理其所处的非市场环境。
2. 外资企业的战略选择要经历一个学习过程。外资企业需要敏锐地理解法律和政策的细微变化，并通过直接的互动和对话获取有关地方制度（包括非正式制度）的知识。有效的学习过程使得企业的适应性调整变得平稳。为此，外资企业需要具有相应的学习能力。
3. 从本地视角出发分析制度的影响很有必要。中国的制度环境在本地层面上体现着多样性。地方政府和地方商业圈在与外资企业的互动中扮演着十分重要的角色。因此，外资企业所面对的是一个本地化的制度环境。从本地视角出发，在研究企业在中国等转型经济中的战略选择时，对制度的量化解释应当考虑“地方”特性，同时，这也要求外资企业经理们在经营管理中应当更多地关注他们所处地方的特定条件。

第一个问题分析了中国外资企业所有权形式的同一性变迁如何受制度自由化和企业战略考虑的影响。研究发现,组织的同一性程度随着外资所有权管制的放松和当地对外资的接纳程度上升而降低。这一发现也验证了制度变化可能会削弱已经建立的同一性(Oliver, 1992; Powell, 1991; Scott, 2001)。另一发现是,组织的同一性随着社会对正当的所有权形式的约定俗成的认识(认知力)发生变化而降低。过去的研究对认知力用一种静态的方式加以处理,我们的研究则强调了其动态特性(Li et al., 2007)。这一特性表明,认知力对组织同一性的影响可能比文献中所实证的更为复杂。同时,该研究的发现显示,组织所有权形式的同一性变迁也反映了外资企业战略考虑的变化。在改革开放初期,外资企业倾向于建立合资企业来实施学习战略;随着时间推移,外资企业逐渐倾向于建立独资企业以实施控制战略。更重要的一点是,该研究的发现支持了市场因素和制度因素在解释组织变化时的互补性假说(D'Aunno et al., 2000; Kraatz & Zajac, 1996)。因此,将二者结合对于解释外资企业所有权形式同一性的变迁具有更强大的说服力。

第二个问题分析了外资企业在中国的所有权形式选择是如何与地方制度互动的。通过多个案例的比较分析发现,我们所观察到的所有权形式通常不同于外商进入中国前所偏好的模式(Gomes-Casseres, 1990),因而支持建立一个两阶段学习过程解释外资企业在中国的所有权形式选择。这个过程区分了偏好和调整两个阶段,表明外资企业的所有权形式并不是简单地由国外总部作出的偏好选择,当外方在中国直接面对地方制度时必然要求对偏好选择进行修正。虽然外方在评估投资模式偏好时已经考虑了中央政策所可能具有的约束,但由于地方层面上政策信息的不对称使得外方在建立企业时有必要对偏好作出修正。过去的研究采用了差异性方法(variance approach),这些研究不能、也没有解释所有权形式的调整过程。该研究所提出的分阶段学习过程综合了不同的理论视角(交易成本、组织能力、制度理论)。这一学习过程有助于对过去研究中不一致的实证结果作出解释,同时提醒学者在研究外资企业的所有权形式选择时应当关注地方制度(地方政府和地方商业圈)的影响。该研究的发现也验证了过程方法对研究企业国际化的洞见力,这与该领域最近的研究进展相呼应(Meyer & Gelbuda, 2006; Tallman & Shenkar, 1994)。另外,研究中增加一个本地视角使得过程复杂了,但对于了解外资企业的所有权选择和国际化战略很有意义(Meyer & Nguyen, 2005)。

第三个问题探讨了外资企业治理与中国地方政府关系的动机和机制。该研究指出了中国与西方在非市场环境方面的不同。在中国,非市场环境的不确定性更多是与地方政府相联系的,表现为政策的模糊性和执行中的随意性。这突显了中国地方层面的非市场环境的特殊性(例如 Bonardi et al., 2005)。因此,外资企业在中国进行政治活动的动因是为了避免地方干扰、争取地方政府的特殊待遇,进而确保企业在本地的运营正常进行。这一本地视角丰富了我们对于国际化政治战略的理解(例如 Rodriguez et al., 2006)。研究表明,外资企

业在本地政治市场上的绩效取决于企业所拥有的技术资源和社会资本（例如 Frynas et al., 2006）。从企业行为来看，外资企业在与地方政府合作时采用关系治理模式，即通过宏观层面的伙伴关系和微观层面的个人关系网来降低交易成本。这种宏微观结合的方式被证明在治理企业外部关系上非常有效（Peng & Luo, 2000）。为了维持这种关系并降低政策不确定性，外资企业会采取诸如提供信息和激励此类前摄性战略行动（proactive strategic actions），但是通常也会同时作出与政府配合的反应式姿态（reactive attitude）作为补充。这一发现是对过去关于前摄性战略行动认识的延伸（Hillman & Hitt, 1999）。这些发现进一步建议，为了更好地治理与地方政府的关系，外资企业必须有效地利用其技术资源，并积极积累在中国本地层面的社会资本。

总之，本论文的研究表明，制度对外资企业在中国的战略选择具有非常重要的影响，是企业在战略决策时必须考虑的重要维度。本文的研究发现对当前国际商务和战略研究领域所关注的制度问题给出了非常积极的回应（Child & Tse, 2001; Meyer & Peng, 2005; Shenkar, 2004; Wright et al., 2005）。此外，针对外资企业战略制定中制度和组织的互动，基于案例的研究也提出了富有见地的建议。本文的这些发现虽然就内容而言是针对中国的，但是就制度影响的分析框架和模式而言，对其他转型经济也是适用的。

Curriculum Vitae



Xueyuan Zhang was born in Yangquan, Shanxi province of China on April 5, 1970. He attended Beijing University of Posts and Telecommunications (BUPT), China, in 1988, from which he received his Bachelor's degree in Management Science and Engineering in 1992 and Doctor's degree in the same field in 1997. His thesis is on management of telecommunication network reliability. Between 1997 and 2000 he worked as an assistant professor at BUPT. In the period of November 1998 through September 1999 he was a visiting researcher at Technical University of Denmark. In May 2000 he joined the research centre of KPN (KPN Research), in the Netherlands. After two years of working in the industry, he returned to academia and joined the ERIM PhD program at the Rotterdam School of Management, Erasmus University, in the Netherlands.

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Strategizing of Foreign Firms in China

An institution-based perspective

China has been assuming a prominent position in the world economy and one of the most attractive destinations for FDI. However, the popular press often points to institutional voids and difficulties that foreign firms face in operation. How foreign firms strategize in China, therefore, becomes a very important question to both academics and practitioners. This book offers an institutional perspective. Based on a detailed analysis of ownership choice and political activities of foreign firms, the book shows that the interaction between institutions and foreign firms accounts much for strategic decisions. In the context of China, it is local institutions, such as local governments and local business societies, which play a substantial role in shaping the behaviour of foreign firms. As a response, foreign firms must “think local”, appreciating the role of local institutions and fitting their behaviour to local circumstances within China. Doing so through a process of learning by doing ex post entry is costly. Therefore, foreign firms need to build up capabilities to manage formal and informal institutions effectively at the local level. From a theoretical perspective, the findings in this book contribute significantly to international business and strategy research into transition economies by contextualizing the existing theories and adding a local perspective.

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