China's Transition and its Implications for International Business

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This paper focuses on institutional change as the central and most consequential contextual aspect of China's transition. Identification of key characteristics of China's emergent institutions leads to propositions on their relevance for international business practice. China's transition also raises issues for theory development, including the way that transition is modeled, the need to draw upon multiple perspectives, and the concomitants of a contextual approach.

China is the most singular of the transition economies. It is the largest, the fastest growing, and the most heavily engaged in international business and investment. China is also unusual because its transition continues to be planned by the state and preserves an active involvement of governmental institutions in business affairs. This distinctiveness is relevant to the study of international business (IB) for two main reasons. First, the peculiarities of China's system generate uncertainties for the international firms that operate there, which are significant because of the country's size and the extent of its engagement with the international economy (Luo, 2000; Peng, 2000). Second, the nature of China's transition challenges the capabilities of present IB theory. The unique institutional characteristics of China's transition speak for the theoretical incorporation of specific socio-economic contexts, a theme highlighted by the editors of a recent special issue of this journal (Toyne and Nigh, 1998).

This paper discusses the policy and theoretical issues that emerge from an analysis of China's transition. It regards institutional change as the central and most consequential feature of China's

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transition, and identifies the key characteristics of China's emergent institutions. This is followed by a set of propositions that summarize the relevance for IB of developments in China. The final section considers the wider implications for IB theory arising from the analysis.

TRANSITION AND INSTITUTIONAL CHANGE IN CHINA

Institutions are social, economic and political bodies that articulate and maintain widely observed norms and rules (North, 1990; Scott, 1995). There are several reasons to adopt an institutional perspective on China's transition to a market economy and examine its implications for IB. First, this perspective enables scholars to delineate fundamental institutional changes in transitional economies, such as privatization (Zahra, Ireland, Gutierrez and Hitt, 2000), and to focus on how these changes impact the behavior of firms (Hoskisson, Eden, Lau and Wright, 2000). It also provides insights on other explanations for business conditions in transition economies, including transaction costs and resource-base theories. For example, a study of China's local governments illuminates how closed and state-dominated systems raise firms' transactional costs (Walder, 1995). Second, agencies such as the World Bank and European Bank for Reconstruction and Development view a country's institutions as impacting causally on its economic development (World Bank, 1996; EBRD, 1999). These agencies help emerging economies by assisting them to set up institutions that ensure private ownership rights, facilitate fair market competition and honor contractual commitments. While some scholars do not agree with the agencies' recommended pace of institutional change or their limited vision of economic prosperity, the significance of a country's institutions for its economic future is not denied. Third, China has particularly strong institutions that are embedded in the country's long administrative tradition, in which government continues to play a prominent role in economic and social affairs. Its institutions therefore lend a distinct character to China's business environment and importantly determine the transition path the country is taking.

Under China's economic reform since 1979, massive institutional change has dismantled many barriers to modern business operations (Child, 1994). However, the study of this change is not a straightforward exercise. Institutional change in China is highly complex because in this formerly closed, state-dominated system, institutions have developed into a massive inter-dependent, multi-level network whose logic of operation depends as much on political influence and personal relationship as on concern for efficiency. Due to the sensitivity of political and social considerations, institutional reform has been non-linear, displaying a mixture of progress and regress (Nee, 1992; Nolan, 1995). It has also been consciously experimental with the result that multiple systems of business ownership and governance have emerged (Boisot and Child, 1996).

KEY INSTITUTIONAL CHANGES IN CHINA

There are three institutional spheres affecting the operations of firms in China - government, the structure of industries and firms, and business-relevant intermediate institutions. Table 1 summarizes the main goals of China's institutional reform in the three spheres, the

TABLE 1
INSTITUTIONAL REFORM IN CHINA: GOALS, MEANS AND LIMITING FORCES

Goals of Institutional Reform	Means of Implementation	Limiting Factors
Government:		
Market economy with socialistic characteristics	Open door policy, creation of a national market and reform of SOEs	Resistance to change by some political factions and SOEs
Withdrawal of government from direct business governance	Decentralization and privatization	Fear of control loss and central-local tensions
Strong & globally competitive Chinese firms	Development of competitive domestic markets and import of foreign technology & know-how	Difficulty for Chinese firms to develop global brands and sustain high R&D costs
Structure of industries and firms:		
An open, competitive structure driven by private and joint stock firms	SOE rationalization and experiments with different forms of business	Unemployment and social unrest
Achievement of economies of scale and scope	Merger and acquisition in the context of a national market	Local protectionism
Favoured development of pillar industries	Retention of government policy involvement in pillar firms	Ability of government to "pick winners" and to grow pillar SOEs into serious competitors to MNCs
Intermediate institutions:		
Professional and efficient business support services	Large effort into managerial, professional and technical training	Resource deficiency (experience & know-how)
	Enlistment of support from foreign professional bodies	Lack of legal & professional tradition
		Government restrictions on selected areas of foreign involvement in services

means adopted for its implementation, and factors limiting the process.

Government

China's central government has been the primary driving force of economic reform. In contrast to European transition economies, China has followed a principle of "pragmatism" with the aim of balancing the pace of reform with social stability (Lin, 1998). This principle has enabled China to support fairly continuous economic reform without open conflict between the country's political factions. It has, however, created uncertainties for both international and local firms as to the exact speed and direction of reform.

There are three fundamental reform processes that the China's central government has adopted and is likely to continue: marketization, decentralization and privatization. They have moved an increasing number of economic transactions from governance by personalized bureaucratic administration to impersonal contractual exchange (North, 1990).

To justify the country's transition to a market economy, its leaders have creatively defined their goal as to develop a "market system with socialistic characteristics". This has meant that some sectors and regions have been more exposed to market competition and have changed faster than others (Dernberger, 1999; Luo, 2000). Nevertheless, by the early 1990s, most transactions in China were being enacted through markets (Naughton, 1994).

Decentralization and privatization signal the diminution of central government involvement in business governance and ownership. Central government has delegated authority to lower level governmental units including provincial, city, and village governments. These "local" governments are now able to formulate their own policies that attract investment and govern business operations under their jurisdiction, within a general framework set by the central authorities (Li and Tse, 1999). The process of decentralization has not been smooth. Central government has not been able to find effective institutional mechanisms to ensure that local initiatives are prudent and consistent with national interests. It is common to find frequent changes of policy by the central government and resistance to such policies by local governments. The fundamental issue is that China is still unable to work out its own system of federalism (Pei, 1999). Privatization is manifest in the way that, since 1979, new types of firm have steadily increased their shares of China's GDP at the expense of state-owned enterprises (SOEs). This has been an integral part of the country's industrial restructuring.

Structure of Industry and Firms

For a long time, firms and governments were welded together into a closed system of networked relationships through ties of state ownership and reciprocal benefits. This multi-level networked system preserved many market imperfections and sustained a fragmented economy with few dominant firms and little competition (Boisot and Child, 1996).

This system has been altered fundamentally by the major shifts in enterprise ownership and growing exposure to market forces since 1979. Before the reform, China's SOEs dominated its national economy, producing three-quarters of its industrial output value. They operated according to bureaucratically mandated plans, including input and output quotas. By 1998, SOEs accounted for only 28 percent of industrial output. There is today a wide range of firms with contrasting ownership and governance structures. Urban and rural collective enterprises account for approximately 38 percent of industrial output, firms with foreign investment 15 percent, and private firms 17 percent (National Bureau of Statistics, 1999). Except for some SOEs, all these firms secure resources and dispose of outputs through markets.

China's industrial structure has become complex and differentiated. The central government now distinguishes between "strong" and "weak" SOEs.

Some SOEs will be retained in strategic industries where considerable economies of scale are anticipated, while others will be sold or dissolved. The government has also encouraged SOEs to merge into business groups, ostensibly to achieve scale economies, but often in reality to bail out weaker enterprises and avoid the social costs of closure (Keister, 2000). Another significant development in the 1990s has been the conversion of SOEs to joint stock companies, of which there were 12,500 by 1997 (Tse and Lau, 1999). Beginning in 1986, foreign direct investors were permitted to establish their own wholly owned subsidiaries (WOSs) as well as joint ventures with local partners, and in 1997 the number of newly-established WOSs exceeded that of new equity joint ventures (EJVs) for the first time. Collective enterprises, especially so-called Township and Village Enterprises (TVEs) owned and operated by village and municipal governments, have become a unique and significant force in China's economy. TVEs are often low-tech, wasteful, and poorly managed (Ming Pao, 1999). Nonetheless, with the collapse of many SOEs, and the increasing authority delegated by the state to local governments in China, TVEs are likely to remain significant players in China. The private sector has been the fastest-growing in China and now employs over 13 million people. In the past, private firms have experienced a harsh institutional environment (IFC, 2000). In 2000, however, they were granted full legal rights, and the establishment of a venture capital market in Shenzhen may provide needed financial capital to the promising few. Not many private firms have so far become joint venture partners or acquisition targets for foreign firms, but some of them will become more attractive especially in areas such as software and internet development (Becker, 1999).

Intermediate Institutions (Business Support Systems)

The third institutional sphere related to business consists of the systems that support the operation of firms. These primarily comprise the legal, accounting, technological, finance, distribution and management education systems. Each has gone through many changes and their future development will have a significant bearing on the capacity of China's firms to compete internationally as well as on the environment that China offers to foreign firms.

Since 1979, there has been continuous legal reform, including regulations governing the status and operations of foreign firms, commercial laws, and laws to protect intellectual property. Yet, the implementation of such laws remains a major source of uncertainty for MNCs because the law in China remains largely "a tool of state administration" (Lubman, 1995:2) and is subject to variations in local interpretation. However, three positive developments can be observed. An increasing number of Chinese citizens are using the legal system to resolve disputes. Second, there has been a large increase in foreign law firms in China. Third, China's entry in the WTO implies that laws of international business will begin to apply.

There is a comparable situation with accounting services. The increasing number of listed firms in China and foreign companies has greatly increased the need for professional accountants to audit firms' operations as well as to advise on modern business practices. Yet with only approximately 60,000 practicing CPAs in China, the demand for accounting services is not yet being met despite the permission given in 1998 to the Big Six accountancy firms to open 27 representative offices and to recruit additional firms. This is partly due to the fact that the government continues to impose restrictions on the type of work foreign accountancy firms can carry out.

China's technological system was the first to undergo dramatic changes. Modern production technologies were introduced to Chinese firms on an unprecedented scale through licensing agreements and EJVs. Chinese firms entered into the global value chain through joint ventures with MNCs as the latter sourced China for low-cost supply in building their global production networks. In recent years, liberalization of the country's huge market potential has encouraged MNCs with advanced technology to include China in their global expansion path. An increasing number of such firms have set up R&D centres in China and some have acquired local internet service providers. In reverse, some Chinese firms are establishing offices abroad in major high-tech regions such as Silicon Valley to acquire technology first hand.

The most obvious milestones in the development of China's financial system are the establishment of stock markets in Shanghai and Shenzhen in the 1990s. Yet the gradual reform of its banking system is equally significant, though far from complete (Rawski, 1998). Only very limited parts of the banking and financial sector have so far been opened to international firms. In its negotiation to join the WTO, the Chinese government has committed to a series of further reforms including the participation of foreign financial institutions. Internal resistance to these proposals has, however, been strong. For China's financial market to function efficiently, it needs a reliable financial reporting and auditing system together with a standardized credit rating system. The Ministry of Finance was due to report on intermediary organizations in late 2000, and is expected to call for the establishment of standards that conform to international practice (China Economic News, 2000).

Before the early 1990s, China's market-distribution system had been very slow to develop. Until 1995, the prohibition of foreign wholly owned subsidiaries in distribution was a major deterrent for foreign firms. Subsequently, the entry of foreign ventures in the retail sector has created some fundamental and far-reaching changes. Most retail development has been initiated by private enterprises and foreign ventures (HKTDC, 1999). The privatization of SOEs is likely to promote further changes in the distribution system because many wholesalers are co-owned by the government.

Another significant factor for China's development is the supply of its human resources, especially those in business (Warner, 1995). While the development of its tertiary education system has been slow (UNDP, 1999), progress in business education has been much faster. In 1988, China's State Education Committee set up the MBA Education Advisory Committee to take responsibility for the country's MBA program development. Over a period of ten years, the total MBA intake in domestic universities has grown from 86 in 1989 to 5,000 in 1999 (State MBA Education Committee Report, 1999). Foreign schools from the USA, Europe, Canada, Singapore and Hong Kong now offer MBA training in Mainland China, often as partners to local universities (Qiji.com,1999). A number of corporations including the People's Bank of China and Changhung have also organized corporate MBA programs for their staff (Economics and Information, 1998). Nevertheless, the demand for MBA graduates in China continues greatly to exceed the supply (Frazer, 1999).

IMPACT OF CHINA'S INSTITUTIONAL CHANGE ON INTERNATIONAL BUSINESS

Transaction and agency costs are known to be high in emerging and transition economies, while resource availability is limited (Hoskisson et al., 2000). Institutional changes in China are expected to reduce transaction and agency costs in a number of ways. The development of efficient markets, with more transparent rules of the game, reduces transaction and information costs, while the institutional specification and enforcement of property rights also reduces transaction costs. The strengthening of property rights reduces the risk of unauthorized appropriation and hence the costs of monitoring the use of technology. This helps to enhance the range of technology that foreign organizations are willing to provide, especially the introduction of advanced technology which itself is an engine for improvements in the efficiency of organizational and work-related transactions.

The development of other intermediate institutions reduces transaction and agency costs by allowing for more contracting out of services and non-core activities and by providing an improving pool of local managerial and technical competencies on which firms can rely. This can also reduce the dependency of both domestic and foreign firms on the provision of resources from outside the country. In China, resource dependency results from a scarcity both of economic resources, such as land, technology, trained personnel and support services, and of social resources, such as relations with government officials and access to business networks. As a result, the realization of first mover advantages often required good government relationships to obtain business licenses and resources that were not obtainable from the market, notably land and distribution channels (Pan, Li and Tse, 1999). As marketization proceeds, and foreign firms learn how to operate within the China context, their resource dependency on local authorities or partners can be expected to decrease. Similarly, as domestic firms improve their technology, knowledge and other capabilities, they become less dependent on foreign partners and the competitive advantage that foreign firms have enjoyed in technology and management expertise is likely to decrease.

The following ten propositions capture the implications of institutional developments for firms' entry and operational strategies in China. The propositions also serve to identify issues for further investigation.

> **P1:** The shift from plan to market increases China's attractiveness as an environment for international business.

Both upstream and downstream markets in China have become more efficient, which reduces firms' information and transaction costs. In addition, the development of a market price system improves resource allocation and hence availability. The shift to market permits international firms to operate within a relatively familiar framework of rules rather than one in which special deals have to be made with government officials. Each of these factors enhances the attractiveness of China as an IB environment, leading to more IB activities there.

The relaxation of institutional constraints upon firms permits local and foreign firms to pursue their preferred business strategies with less restriction than before. Foreign firms are accustomed to pursue a differentiation strategy based on superior design, quality, and strong brand appeal. Until recently, however, they could not take effective legal action against brand piracy because of institutional limitations. Most Chinese firms are using pricing strategies to compete. They acquire internationally standardized production technology, capture cost savings through large-scale production, and pass these savings on to consumers by offering products that match consumer budget constraints. Some of them replicate this strategy to gain market share and to enter other developing economies.

P2: China's increased exposure to market and global forces allows MNCs more flexibility in their choice of entry and operating modes.

The commitment to marketization and continuous opening to the world economy lead to increasing competition within China's domestic economy, as well as allowing the central government to argue for and practice policies that comply with international standards. As such, MNCs can enter China through all types of modes with greater confidence (Vanhonacker, 1997). This is in contrast to former practice under which many industries (e.g., import and export, internet services) were exclusive to local firms or restricted to joint ventures with such firms. As part of China's movement towards privatization, business operations are becoming detached from government ties. Tendering processes are increasingly common in business and public sectors. For MNCs entering China, this disengagement implies that their consideration of whether to form joint ventures and their choice of partners will be determined less by the latter's ability to work with the government, and more on how the two firms complement each other and the ability of the joint entity to develop sustainable competitive advantages.

P3: As government withdraws from direct participation in Chinese enterprises, weak domestic firms will seek the equity participation of foreign companies.

The diminishing participation of government in business is manifest in a withdrawal of subsidies to SOEs (and some collective enterprises) and the decentralization of business initiative to them. This change implies that firms with government links can no longer enjoy artificial economic rents. This encourages some local firms to seek foreign financial injections through sale of equity or via a joint venture. By contrast, some stronger domestic firms will have an opportunity to raise their own finance in the stock market in the light of the projected banking reform and liberalization of funding regulations. This will make them less motivated than weaker firms to invite foreign participation in their equity ownership.

P4: The growing spread of ownership and governance forms in China will lead to a greater variety of types of co-operation between Chinese and foreign firms.

The liberalization of ownership and governance forms offers a wider choice of partnership arrangements to foreign firms and allows decisions about partner choice to be based increasingly on rational considerations of strategic intention, risk, and transaction costs. Regarding strategic intention, the market-seeking intentions that have been the prime motivation for entry into China will present less of an inhibition on choice of structure than previously when government authorities often made market access and distribution rights conditional upon forming a minority share joint venture with a local partner. Regarding risk, with fewer institutional constraints the choice of structure can more rationally reflect form functionality for financial and agency risk. The greater the aversion to financial risk, the more a shared equity solution will be preferred. The greater the aversion to agency risk, the more a wholly-owned solution will be preferred. Thus while a foreign SME unfamiliar with China and not able to risk large capital resources might prefer to find a local partner, an MNC with advanced proprietary technology might prefer to invest sufficiently to guarantee the right to control and to make key appointments. Regarding transaction costs, the greater variety of ownership options makes it easier for firms to enter governance arrangements that minimize transaction costs. Different arrangements might therefore be made for R&D, production, and distribution. The specific human and technical assets required for R&D, combined with intensive co-ordination and communication requirements, are likely to make this a preferred candidate for exclusive hierarchical control, while the conditions in distribution may favor local partnership or agency.

P5: China's entry to the WTO will encourage foreign firms to adopt a longer term view of operations there and to consider making China part of their global supply chains.

MNCs are known to choose their entry strategy contingent upon the risk, costs and control associated with the venture. For the past two decades, political events and institutional changes in China have led many foreign firms to perceive their China operations as "non-permanent" and some have opted for non-equity based entry modes (Tse, Pan and Au, 1998). With China's entry to WTO and its associated institutional developments, firms are likely to adopt a longer-term perspective towards operations in China. This will motivate them to consider equity rather than non-equity based modes with larger investment commitments. Over 50% of MNCs active in Asia are considering making a China operation part of their global value chain.

P6: The development of competitive domestic markets equips strong Chinese firms to internationalize their operations.

Seventy percent of the top three brands in 50 consumer product categories are from local Chinese firms (HKTDC, 1998). Given the size of the China market, these firms may be able to leverage this domestic market power to expand internationally, a strategy that has proved to be effective among newly emerged Asian firms such as Taiwan's Acer and South Korea's Lucky Gold Star. A few domestically strong companies (such as Haier and Legend) have already successfully expanded into overseas markets (The Economist, 1999; Zhang, 2000). Whether many Chinese firms can catch up with the giant global corporations is, however, more doubtful (Nolan, 1999).

P7: Policies on China's business support systems will increasingly be tailored to the needs of its privately owned and foreign-investing firms.

The underdevelopment of China's business support systems was partly due to the previous autarky of SOEs and high levels of governmental protection. Competitive pressures, and the introduction of new accounting, legal and other standards, are now obliging these and other firms to seek professional support. Standards and policies for the operation of business support bodies are similarly being formulated. As the economy becomes increasingly privatized, it is likely that policies on business support services will emerge that suit the needs of privately and foreign-owned firms. Foreign professional bodies and some MNCs are actively involved in advising on the formulation of such policies. In China's insurance industry, for example, foreign companies have helped to formulate provisions to allow insurance firms to extend their investments beyond bank savings accounts and government bonds to stocks and other financial derivatives.

P8: The development in China of legal support for the terms of contracts and of transparency in legal and accounting processes will encourage a shift from personal to impersonal enforcement of business transactions.

Despite its many continuing imperfections, the legal system in China is adjusting from a mode of accommodating conflicts informally (often through personal mediation) to one in which the terms of contracts will be decisive and adjudicated in the courts. This is paralleled by the shift on the part of central and local governments from a social to a corporate governance model in their relations to business. The growing use of a transparent and rule-based system of law and business accounting reduces uncertainty and concomitant transaction costs for both domestic and foreign firms.

P9: Business support systems in China will form part of the global business services network.

China's acceptance into the WTO is another endorsement of its entry into the global economy. It implies that laws governing international business operations should become effective in China. This lowers both the financial and operational risks faced by international firms and it encourages their participation in the Chinese economy. In turn this participation increases the scale of China's business services market, and encourages more international service providers to recognize China as a key market. From auditing firms to management consultants, from courier services to business hotels, many are already reorganizing their Asia organization. Often, they are expanding from a dual regional organization for Japan and the rest of Asia, to a tri-regional organization with China being the new component. At the same time, foreign business service providers find it increasingly necessary to localize their middle and senior staff so as to offer competitive services sensitive to the local language and conditions.

P10: The strengthening of support systems for business via more effective intermediate institutions will assist the integration of China with international business.

The reform of financial systems, growth in business support services and technical and management education, and improvements in infrastructure improves the availability of locally-specific resources. This encourages the entry of more foreign firms into China and the localization of more activities by foreign firms already operating in the country. Both features enhance the integration of

China into the international system. Moreover, as the quality of China's human resources improves, more technology driven firms will enter the country to use it as a base for serving their Asian markets and to extend their R&D capabilities. This will increase the proportion of foreign firms investing in China to enhance their core resources rather than simply to exploit their existing resources through market access.

The strengthening of intermediate institutions in China will accelerate its firms' entry into global markets. The speed at which Chinese firms can become global players depends on the enhancement of domestic resources and support systems, especially in human competencies, technology and professional and consulting services. The lack of these competencies has inhibited the ability of Chinese firms to internationalize (Cai, 1999) and to close the gap with MNCs (Nolan, 1999).

IMPLICATIONS FOR INTERNATIONAL BUSINESS THEORY

China's transition has three related implications for future developments in international business theory. These concern the way that transition is modeled, the need to draw upon multiple perspectives, and the concomitants of a contextual approach.

Modeling the Transition Process

The conventional view of transition envisages a process of institutional change emanating from the country's growing exposure to global material and ideational forces. The exposure is expected to foster the development of efficient markets, business accountability, and supporting competencies. Institutions defining the contextual rules for business operating in a transition country like China are expected, in effect, to mediate between global forces and individual firms. This two-stage model of the change process is broadly consistent with developments in China, but requires some qualification.

Firstly, it would be an oversimplification to assume that global forces only impact upon individual firms through their effects on national institutions. Although China has a strong sense of protective state paternalism, this does not remove the direct influence global forces exert on some firms. Those firms that are active in overseas markets, have partnerships with foreign firms, or face direct competition from foreign firms, will experience a more direct impact of global forces. Equally, in some firms local staff will by dint of their age, training and experience be more receptive to ideas originating outside the country than their counterparts. Ralston et al. (1999) have, for instance, found evidence of a shift across generations of Chinese people towards the western values of individualism and materialism. The key point is that one cannot assume that firms are similarly located vis-à-vis the global context or that this location will not change over time. Some firms and their staff are more directly linked with global forces than others.

Secondly, there is a danger of overlooking the pro-activity by some international firms towards national institutional bodies. Large, resource-rich MNCs are in a position to negotiate financial and other concessions with national governments (Aldrich, 1979). Moreover, foreign firms often have the expertise to assist in the formulation of business-relevant policies in a transition economy, and through their advanced technology they may be in a favorable position to set technical standards.

Thirdly, an adequate transition model needs to define the scope and role that firms, governments and supra-national bodies play in the transition process. These roles change over time. So far in its reform, China's central government has been the chief driver for change, especially to overcome the obstacles embedded in provincial politics and firm-government relations. As power continues to be delegated to local governments and to the market, the roles played by the latter in China's future transition will become more prominent. Moreover, China has sought assistance from supra-national bodies like the World Bank and taken heed of their recommendations. As it becomes increasingly involved in world trade, the WTO will assume increasing relevance for the trade and investment in its transition. Models of transition need to capture these changes and how they emanate from the roles played by bodies at different levels.

Need for Multiple Perspectives

Most attention to the logic of China's transition has centered on its economic and technological imperatives. This focuses on the creation of efficient markets and the conditions for technology transfer. Both economic theory and the theory of technological change are "low context" perspectives in that they minimize the impact of national distinctiveness (Child, 2000). They presume an eventual convergence as transitional nations become more engaged in an increasingly efficient global economy. Even studies that identify considerable national differences (e.g. World Economic Forum, 2000) imply that China has a simple choice between participating in this global convergence or foregoing the benefits of economic development.

North's (1990) analysis of institutions and economic performance points to the relevance of historical factors that inhibit a country from adopting institutional solutions which conventional economic theory would regard as optimal. Major provisions in a country's constitution or customary practice laid down in the past can create a path-dependence that steers institutional development in a certain direction. North also argues that informal constraints come from the cultural transmission of values, underpinned by ideological reinforcements. He maintains that these historical and social influences on institutional development do not necessarily have harmful economic effects. Thus, it may not be valid to presume a universal optimal institutional pattern towards which transition should proceed.

North's caution, and the evidence from China of "stickiness" in institutional change, confirms that we need to adopt a multi-disciplinary perspective when we theorize about the contexts of international business. The interests and influence of social and political organizations also need to be taken into account (DiMaggio and Powell, 1991). In China, the central government attaches paramount importance to the need for the Communist Party to be in control and it intends to balance the pace of economic reform with social stability (Tse and Lau, 1999). The operation of these salient socio-political factors may result in the emergence of other forms of capitalism and an absence of convergence. They give rise to scenarios that low-context theories cannot account for by themselves.

Concomitants of a Contextual Approach

In a recent discussion, Toyne and Nigh (1998) suggest that contextualization offers an opportunity for the further development of IB theory. Two inherent characteristics of the "China" context provide insights for such development.

1. State paternalism. The pronounced mediation of global forces by China's institutions recalls the significant role that the state retains in some transition economies. China, and to a lesser extent the other large economies of Russia and Ukraine, exhibit a form of transition from socialism that retains considerable state intervention in the economy and state sponsorship of firms. State sponsorship is informed by a combination of political and economic motives. It has a long tradition that predates the socialist period. The state in both China and Russia has consistently accorded to itself a paternalistic role towards business since the first days of industrialization before the First World War (Nolan, 1995).

Even after twenty years of reform, state paternalism remains a dominant feature of China's business environment. So long as China retains its one-party system, this feature is likely to persist. Currently, the state retains much of its controlling role in the business system (Richet and Huchet, 1999). Even as former SOEs convert formally into joint stock companies, government normally retains a significant ownership stake which it administers through asset management agencies. Moreover, it continues to reserve powers to determine the rules of the business system and to define the different categories of firm and the rights appertaining to them, including approval to engage in international trade and capital markets. The state also exercises control over the terms of foreign entry into different sectors, and in so doing considerably influences the exposure of domestic firms to global competition. Thus bureaucrats have erected non-tariff barriers to protect domestic companies, including "buy local" orders for industries such as mobile telecommunications equipment, certain pharmaceutical products and some power generation equipment (Johnson, 2000).

One consequence of this heavy state involvement is that within China there are several categories of firm differentiated by (1) the extent of their interdependence with the state and (2) the approved basis on which they can engage with international business. The fact that the main source of this differentiation between firms lies in the institutionalized economic role of the state and not just market forces speaks for some broadening of international business theory.

Nor should it be expected that state paternalism will necessarily be discarded because of entry to the WTO or in response to other calls to abide by the "global standards" of international business. The Chinese authorities have made clear their determination to retain certain institutional practices and to legitimize these in the forum of world trade. Examples are their right to retain ownership and control over strategic industries and to determine the pace of economic liberalization (de Jonquieres, 2000). There is a distinct possibility that the greater involvement of state paternal countries in the world economy will increase pressures to change the rules of the international business game, particularly with respect to the control of key assets and capital flows. IB theory needs to take state paternalism into account as the economies marked by it and their constituent firms increasingly engage with the world economic system.

2. Complexity in transition economies. Another theoretical challenge is presented by the complexity of transition economies. The example of China has indicated that transition is not deterministic in nature, but involves an interplay between a field of forces operating at different system levels. This view is also supported by experience in Eastern Europe (Child and Czeglédy, 1996). China is intrinsically complex by dint of its size and internal variation. This complexity is being amplified by the way that its leaders are addressing transition. As noted, they are endeavoring to change the country's institutional legacy through a policy of disequilibrium and non-linear progression intended to accommodate basic strains within the system, especially between the goals of reform and social stability. The inability to apply a simple linear model of transition means that international firms need new tools to function in dynamic and complex environments. The challenge for their managers is how to model non-linear complexity and analyze its implications.

The transactional options available to reduce such uncertainty enrich our appreciation of international business strategies in transitional environments. Two major methods for handling complexity - reduction and absorption - have been identified (Boisot and Child, 1999). Complexity reduction attempts to reduce complexity by bringing it under apparent control. Firms endeavor to do this by securing direct control over their affiliates and sufficient external influence so as to enact critical aspects of the environment. This policy is intended to permit firms to apply their standard policies and practices, which are well understood and compatible with their worldwide activities. In China, reducing reliance on partners and external relationships will lower the transaction costs of social exchange, but it is likely to raise the transaction costs of exercising direct managerial control using expensive expatriates. Moreover, this policy could be of limited effectiveness in reducing risk because it places low value on the support of local partners and may also alienate powerful officials in the institutional environment. These factors point to a distinct limitation in the ownership advantages enjoyed by foreign firms operating in China, which may contribute significantly to their often disappointing performance in that country.

The second option is to try to absorb the complexity of the Chinese situation through enlisting the support of local allies. This entails a greater degree of participation in local relational systems and hence raises the transaction costs of social exchange. It also engages the foreign firm in a greater level of variance than it is familiar with, which may limit its ability to relate its policies and practices in China to its worldwide system. On the other hand, complexity absorption can increase the firm's ability to learn and open up a greater range of options for it. It is broadly consistent with the management of uncertain opportunities by pursuing a number of high-variance outcomes as "real options" (McGrath, 1999). It is also historically the approach adopted by the Chinese themselves to cope with their environment. Essentially, it attempts to reduce risk by co-opting those who can help to anticipate and interpret change and who can suggest a range of alternative actions. So long as there are adequate mechanisms for resolving conflicts with partners, this co-optation should also reduce the transaction costs involved in exercising direct managerial control.

Policy choices of this kind are clearly relevant to the basis on which international firms engage with Chinese counterparts. They illustrate how the particular case of China offers an opportunity to examine the trade-off between different kinds of transaction costs in the process of reducing risk in a complex and uncertain environment. This is a theoretical avenue worth pursuing further, particularly if it is combined with an examination of relevant contingencies. Thus certain conditions may bear upon the ability of firms to enact their environments and adopt a complexity reducing approach successfully, or alternatively to handle complexity via the absorption approach. For firms operating in China, their ability to enact local environmental conditions will clearly be a function of factors such as their global reputation, and their skill at generating political goodwill. Smaller firms may not have the resources, standing or experience to adopt this policy, and will hence tend to rely more heavily on coping with China's complex environment through the assistance of partners.

In short, China presents a challenging scenario for both the theory and practice of international business. It has to be understood in its own terms as a political economy rather than just a large marketplace. Its transition has quite distinctive institutional characteristics, and these can inform the endeavor to construct more context sensitive theories of international business. An institutional analysis of China's transition thus contributes to the "more expansive" view of the subject advocated by Toyne and Nigh (1998).

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