

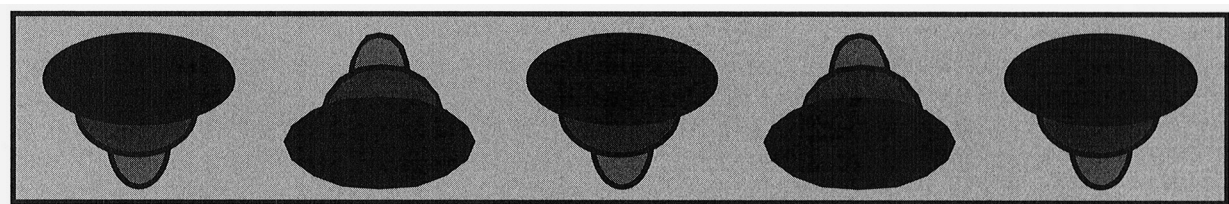
Managing the Institutional Environment: Challenges for Foreign Firms in Post WTO China

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After nearly 15 years of negotiations, China was formally invited in 2001 to join the World Trade Organization (WTO). This capped an historic year that included the award of the 2008 Olympics to Beijing and the hosting of the Asia-Pacific Economic Cooperation (APEC) summit in Shanghai. Accession to the WTO offers many opportunities for China and multinational firms, as well as numerous challenges. With China agreeing to abide by global trade rules, barriers to foreign goods and services will shrink, and the door for foreign investment will be open more widely than ever before (Panitchpakdi and Clifford, 2001).

There are opposing views regarding the effects of China's WTO accession (Nolan, 2001a). On the one hand, foreign firms and labor unions worry about the ability of Chinese firms to dominate lower-end manufacturing similar to the way Japanese and Korean firms have in the past (Panitchpakdi and Clifford, 2001). While China's competitors fear its inexorable rise, China's firms worry about numerous, experienced, well-financed, technologically advanced foreign competitors that are almost certain to enter a wide range of Chinese markets and industrial sectors, many of which have been largely untouched by foreign competition (Nolan, 2001a; O'Neill, 2002).

Despite the divergent viewpoints most observers agree that an immediate result of WTO entry will be increased flows of foreign direct invest-

ment into China (Panitchpakdi and Clifford, 2001). The WTO agreement will also give foreign firms¹ more freedom to operate in a variety of industrial sectors and regions of the country (Nolan, 2001b). Restrictions on retailing and distribution will ease as foreign retail firms are able to set up wholly owned outlets; no longer will most goods sold have to be produced in China. Significant restrictions on distribution will be phased out over three years (Panitchpakdi and Clifford, 2001). In telecommunications, foreign players will be able to buy up to 50% of telecom carriers. A number of other regulations will be loosened, opening up a range of previously closed industries from banking to agriculture. In addition, the Chinese government is encouraging firms to locate in the country's more remote areas (Schlevogt, 2001).

The cumulative effect of the relaxation of restrictions on foreign firms is that WTO will not only bring more foreign firms to China, but will offer them unprecedented access, particularly in industrial sectors and geographic regions that have seen few foreign enterprises of any kind. This has implications in a number of areas, but perhaps the most proximate is that China's accession to the WTO will increase the number of foreign firms entering China, which, in turn, will face problems issuing from China's underdeveloped institutional environment. This includes formal commercial laws and regulations, unwritten norms and practices, as well as common, taken-for-granted behaviors of firms and individuals (Boisot and Child, 1996; Scott, 1995, 2002).

¹ The term "foreign firms" paper is meant to mean non-Mainland Chinese firms operating in Mainland China.

Prior to WTO accession, foreign firms were compelled to enter China under strict guidelines and were limited to certain sectors. They typically chose to locate in the more developed coastal areas of the country where regulations were codified and commercial traditions well established (Scarborough, 1998). Therefore, a foreign manufacturer could expect to encounter fairly clear (if not always logically consistent) laws and commonly accepted commercial practices in the most likely locations for businesses in that sector (usually manufacturing). As significant numbers of foreign firms enter China after WTO, they will have unprecedented access to different regions and industrial sectors. However, these are locations and industries with less established commercial law and little experience in commercial practice. The institutional environment will differ from what foreign firms are familiar with (Bruton and Ahlstrom, 2002).

This paper examines the challenges foreign firms are likely to face as they enter new industrial sectors and regions of China and ways in which they have started responding to these challenges.² In addition to surveying the literature on key elements of China's institutional environment, we interviewed top managers, consultants, and legal specialists in China. They provided background for the study as well as up-to-date information on how recent entrants have been coping with the changing institutional environment. In particular, we examine portions of China's institutional environment most closely related to commerce: the legal system, enforcement norms, and commercial customs.

Background

China launched its Economic Reform and Open Door Policy in the late 1970s, drawing many foreign firms to her shores. However, most firms knew little about doing business in China and less about the way in which its institutional and legal structure could affect firm success (Mann, 1997; Wong et al, 1999). Many were surprised by the lack of legal infrastructure and commercial tradition to guide business transactions (Mann, 1997; Peng and Heath, 1996). The institutional environment, including property rights, contract law, company law and arbitration, and numerous commercial customs, differs considerably from that of the West (Chen, 2001; Scott,

² Private firms are defined here as non-government-owned firms. In China, different levels of government can own firms.

2002), and this has a number of implications for firms and investors as they move into China (Peng, 2000).

Institutional theory maintains that the beliefs, goals, and behaviors of individuals and organizations are strongly influenced by subtle but pervasive forces in the external environment (Scott, 1995; DiMaggio and Powell, 1991; Child, Faulkner and Pitkethley, 2000). Three principal types of institutions affecting organizational activity have been identified (Scott, 1995). Regulatory institutions function through the use of laws and sanctions. For example, insider-trading laws discourage individuals and firms from such activity. Normative institutions may also be codified but can be more tacit in defining the roles or actions that are expected of individuals and firms (Freidson 1988, Mezias, 1990, Starr, 1982). Finally, there are cultural/cognitive institutions that are most closely associated with, but not limited to, cultural elements in a society (Jepperson, 1991; Scott, 2002). These include informal constraints embodied in traditions, taken-for-granted conventions, and subconsciously accepted rules and customs. Such institutions develop over time through social interactions, reflecting actions are appropriate and conceivable (Berger and Luckman, 1967). In a commercial context, cultural/cognitive institutions would include conventions concerning fair competition, customer service, and obeying the rules of an industry and society (Busenitz, 2000; Scott, 2002). Such rules exercise their influence quietly on maintaining relationships and mutual obligations in Chinese societies (Chen, 2001).

China's institutional environment, with the nation's socialist tradition and strong culture, differs considerably from that of the West (Boisot and Child, 1996; Peng, 2000; Peng and Heath, 1996). For example, firms often must engage in transactions where personnel connections matter more than firm capabilities (Xin and Pearce, 1996). Thus, for researchers, China's institutional environment provides a compelling context for examining and refining our understanding of how institutions may affect firms (Boisot and Child, 1996; Peng, Lu, Shenkar and Wang, 2001).

The Study

To better understand challenges arising from China's institutional environment we conducted interviews with seven individuals closely involved with foreign firms in China. Because

the handling of legal issues and related disagreements in China can be sensitive, and respondents are often reluctant to fill out questionnaires, we conducted face-to-face, semi-structured interviews on conditions of anonymity. The interviews were conducted in Hong Kong and Mainland China, most often at the interviewee's site. One of the subjects had experience as a general legal council with a major multinational enterprise in China; another subject was the founder of a China-based consulting firm that also deals regularly with legal problems of foreign firms in China. The other five were senior managers of large foreign firms with extensive operations in China.

The interviews were open-ended, but a standard questionnaire provided common ground without overly restricting the parameters.³ While a small sample of cases can create questions of validity, the rich information obtained is useful for grounding existing theory with substantive observations (Lee, 1999), and in building insights in a rapidly changing domain (Strauss and Corbin, 1990).

Research Results

Many problems in China's institutional environment relate to commercial law and foreign firms must contend with deficiencies in China's legal and enforcement regime in a number of areas (Lubman, 1999; Peerenboom, 2001). Regarding some of the current legal challenges, one legal scholar observed:

the Party's incomplete retreat from day-to-day governance and the battles for power among the emerging state organs, the weak stature of the court, the improving but still low level of professionalism among the judiciary and legal profession and the low level of legal consciousness among the public interact in a variety of sometimes expected, sometimes unexpected ways to generate a wide and diverse range of enforcement problems in each of the areas of law (Peerenboom, 2001: 318).

Interviews with the managers of foreign firms and legal experts in China confirmed this and

³ This interview method, known as a funnel technique, is commonly used with grounded theory (Glaser and Strauss, 1967). A funnel interview is structured such that initial information provided serves to help verify categories or create new ones. It also helps direct the interviewers to a finer level of detail through follow-up questions (Frey and Oishi, 1995). This technique is effective in gathering fine-grained information about key events, firm operations, and problem-solving and extracting common elements.

outlined what foreign firms might expect in terms of these problems. These issues are discussed and summarized in Exhibit 1.

• Regulatory institutions: law-related problems

The regulatory component of institutional theory is concerned with codified rules and laws and their impact on organizations and individuals (North, 1990). China is often thought of as a strong central government with harsh laws, but, in fact, the concept of codified law in many areas of China is quite new (Lubman, 1999). Other than the penal code, some of which has been in use for 2000 years and can be quite draconian (Becker, 2000), Chinese citizens and businesses are generally not governed by codified law (Jenner, 1992). People are expected to live under the Confucian code of *li*, which holds that civilized people should behave morally, in deference to others, learning morals from their teachers and superiors (Greer and Lim, 1998). This civility stopped short of providing a formal code of living, as it was not necessary for a civilized society to have written laws: civilized people simply know how to behave.

This lack of written law extended beyond the civil code to most areas of Chinese society. One expected outcome was that legal systems, such as they were, varied greatly from region to region, depending on local traditions and who was in charge. This helped give rise to the foreign concessions in China's treaty ports as foreign firms (and even local Chinese merchants) preferred the predictable and reasonably even-handed European adjudication (Becker, 2000; Clarke, 1991; Scarborough, 1998). After the 1911 revolution, the Kuomintang government was able to develop statutory law and build a body of case law precedent, particularly in the commercial arena. In 1949, the People's Republic government threw out those laws, replacing them with essentially nothing except laws concerning the authority of the State (Becker, 2000). China has recently started to develop statutory law and build case law. Yet both elements of the regulatory environment are quite new; codified law is still underdeveloped and varies greatly among different regions and industrial sectors (Lubman, 1999). Indeed it could be argued that China's present legal system still functions more as a mechanism of public order and control for the government, the role that Mao prescribed for the courts and judges in 1949 (Jenner, 1992).

Exhibit 1. Summary of institutional challenges for foreign firms in China and their responses

Institutional Aspect	Problem	Firm Response
Regulatory Institutions	<ul style="list-style-type: none"> • Lack of codified law • Archaic Penal code • Variation in legal system across regions • Laws oriented towards public order and control by government • Interference by bureaucrats and regulators • Arbitrary enforcement of law by regulators 	<ul style="list-style-type: none"> • Develop organizational knowledge of local law • Awareness of legal developments and relevant legal issues in region • Identify gaps in law that can be source of problems • Do not assume laws are uniform • Designate official to liaison with local government officials • Build relationship with bureaucrats, local officials and respond to queries about adherence to legal codes
Normative Institutions	<ul style="list-style-type: none"> • Interpretation and enforcement of law subject to political influence • Practice of bribes and corruption distorts law enforcement • Laws enforcement influenced by networks of relationship 	<ul style="list-style-type: none"> • Develop policy on influencing legal outcomes • Develop intelligences on changes in political environment • Buy <i>guanxi</i> -- Hire local individuals with connections/status in the community for liaison work
Cultural and Cognitive institutions	<ul style="list-style-type: none"> • Conflict resolution through informal mechanisms • Lack of business conventions • Trust in relationships and known networks 	<ul style="list-style-type: none"> • Build <i>guanxi</i> -- Develop long-term, local relationships • Establish alliances with powerful or politically connected firms – often State-owned Enterprises or firms controlled by well-connected individuals.

This lack of codified law means that bureaucrats and powerful individuals are sometimes able to interfere with foreign firms' operations on a variety of levels, not unlike the way some Mandarins did under China's dynastic system (Lubman, 1999). The propensity to use their influence arbitrarily for personal gain has persisted through today (Boisot and Child, 1988; He, 1997; Nolan, 2001a). In a recent empirical study, Peng and Luo found:

All of these [government] officials, who can be regarded as your "mothers-in-law," absolutely have to be pleased. If you fail to do that, you may be forced to close your factory without knowing what's wrong at all . . . On the other hand, if these "in-laws" are happy, they can make life a lot easier for you. Sometimes they make you think they have the magic touch to make anything happen. For example, they can procure cheaper materials for you, provide priority access to infrastructure, and promote your products in state-controlled distribution channels (2000: 495).

Laws and regulations are often interpreted by people with jurisdiction over a given industrial sector, department, or region (Peng and Luo, 2000; Tan, 1999; Tsang, 1996). This means that officials can issue fines, order firms out of certain markets, and even close companies down if they are not satisfied with responses to their demands. Foreign firms can expect officials to make regular visits to ensure that local “regulations” are followed (Ahlstrom, Bruton and Lui, 2000). A managing director of an electronics manufacturer explained:

There are many officials from various departments that pay our plant regular visits. They come with seven or eight other colleagues with the stated purpose of checking to see if we are complying with their regulations. Of course they will find something wrong if we let them, so we try not to let them. One person in our firm, who is nominally the factory manager, is responsible for maintaining a relationship with these officials. When these people show up at our plant, he will immediately bring them to a nice restaurant for a banquet. There may be some gifts or favors involved as well. They will show up half a dozen times a year always around 6:00 p.m. expecting this sort of treatment. It is expensive, but the alternative is more costly. And they are only one department. You can expect to get a similar series of visits from a dozen or more departments and bureaus over the course of a year (Ahlstrom, Bruton and Lui, 2000: 9).

Although certain localities in China such as the manufacturing center of Dongguan in Guangdong province have done a good job of codifying local regulations and limiting the power of officials, these locations are still exceptional. Firms may find they have little remedy if they feel an official is being unreasonable or a sudden, unexpected fee is unfair. Indeed the managers in our sample agreed that dinners, gift giving, and favors are often part of the cost of doing business in China, especially for smaller, less connected firms, and must be planned for.⁴

• Normative institutions: enforcement-related problems

Normative institutions are those that represent proper norms and roles (DiMaggio and Powell, 1991). These may be written, but are less formal

⁴ When pressed on how costly this could be, one of the senior managers in our sample estimated that expenditures associated with socializing with officials and keeping them happy added 50% to their regular operating costs.

and usually do not carry the force of law (North, 1990; Scott, 1995). In terms of commerce, norms include how firms are supposed to behave in the industry (competitive norms), how they should treat the customer (commercial norms), how employees should be treated (labor norms), and the role that government is expected to play in commercial affairs (policy norms).

Many observers believe that in China the government needs to increase its role in enforcement of judgments (Boisot, 1987; Peerenboom, 2001). Enforcement has always been a difficult issue, commonly settled only by payments to a key party such as a judge or arbitrator, who will then settle the dispute favorably (Lubman, 1999). This is due in part to the fact that lawyers and judges remaining in China after the fall of the Kuomintang had largely disappeared by the late 1950s (Jenner, 1992). Some judges and other legal officials were retained, but they were discouraged from upholding previous principles of law or writing opinions to create a body of case law precedent. One problem that has proved particularly knotty is the area of interpretation and enforcement of the law. Generally, this was based on implementing (and interpreting) the will of the Party rather than on common commercial norms or (organizational) property rights. This left enforcement of judgments open to much interpretation, not always in the hands of a disinterested party such as the police. Recalled one former general manager of a luxury goods manufacturer and distributor:

One time we were having a problem with a large shipment of watches that we sent to a store in [a northeast province of China] . . . The store said the shipment never arrived, although the shipping company said it had been delivered. After some investigation, we discovered that a manager at the store had conspired with another employee to steal the shipment and sell it themselves . . . After our investigator held some discussions with the local police and other officials there, we decided not to pursue the case. Although everyone knew what had happened, no one wanted to do anything about it. We could have pursued the case, but we would have had to ‘compensate’ the police, the judge, the customs agents and others for taking time out to prosecute the perpetrators. We thought it would cost too much in terms of both money and good will . . . Sometimes these government guys will tell you with a straight face that their salary just pays for them to show up for work — if you want them to do anything additional, you must “cover their expenses.”

Several of the managers we spoke to add that the police could not be counted on for help in investigating crimes or enforcing judgments, though they stopped short of using the term “corruption” to describe legal practices in China. Instead, they said these departments were “indifferent.” Commenting on the problems, the managing director of a toy factory in southern China observed:

Some people you hire will be very dishonest but since they are from far away [provinces] its difficult to know who can be trusted. There are local toughs that can also extort money if you do not have any protection. The police do not provide us with much help, either you need to perform your own security or you have to find local people who can help you.

The manager added that foreign firms might be able to secure protection from local individuals with influence in that community. In smaller towns this could be the *cun zhang* or Village Head — an individual respected by the locals (Ahlstrom, Bruton and Lui, 2000). In larger towns and cities, it is good to have connections with people in the city government and key agencies that have important jurisdiction over the firm as well as other influential (sometimes state-owned) organizations (Peng and Luo, 2000).⁵ The consultant interviewed added that it is also useful for firms to hire lawyers with relationships with local judges and law enforcement personnel, to facilitate getting judgments enforced, at least in that locality.⁶

• Cultural/cognitive institutions: contracts and obligations

Cultural/cognitive institutions include informal constraints embodied in traditions and taken-for-granted customs. These are less formal than normative institutions and are often subconsciously accepted, seldom questioned. The significance of key cultural institutions such as

⁵ According to a 1993 survey, over two-thirds of judges in China reported that as a rule they were subject to outside interference. They cited the following sources: Chinese Communist Party, 8%; other government bodies, 26%; other, 4%; and perhaps most important, social networks, 29% (Gong, 1993).

⁶ Connecting with the right officials and legal personnel may have to be repeated in each locality the firm does business in something of particular interest to retailers (Ahlstrom, Bruton and Lui, 2000). As political scientist Kenneth Lieberthal has observed, China is characterized by clearly demarked, fragmented authoritarianism (Lieberthal, 1995).

guanxi (connections, relations) and propriety (*li*) is often traced to the Confucian emphasis on social roles and clan ties. *Guanxi* in particular, can play a role in the key commercial area of contract implementation — an area of the law open to much interpretation (Peerenboom, 2001). Indeed, contract law has been a major area of legal practice and scholarship in the West since the age of the Greek city-states.⁷ The Chinese legal system generally allowed the guilds, clan organizations, and other nongovernmental groups to resolve contract disputes and decide when people or firms were not upholding their end of an agreement. The courts would get involved only as a last resort, usually in response to the seizure of property or disorderly behavior (Jenner, 1992).

After economic reforms began in the late 1970s, contract enforcement once again became an important issue as commercial activity started to expand outside the state-owned sector (Naughton, 1996). Traditionally, the guilds and clan associations so important among Chinese commercial groups enforced contracts. Contracts were also designed to be self-enforcing, often using a guarantor middleman who would compensate one party if the other failed to deliver the product or service (Jenner, 1992). But contracts were traditionally not well codified, and people in China were traditionally comfortable with this degree of ambiguity (Chen, 2001). But without having previous connections or building mutual obligations, foreign firms often find it difficult to enforce even simple, implicit contracts. Most firms entering China are not accustomed to doing business in this way, as the managing director of the toy manufacturer explained:

Without the proper connections to the local bureau of posts and communications, we found it difficult to get our mail delivered. They felt that they did not have any obligation to us to deliver the mail regularly and on time and we had no method to compel them to improve delivery. Some days, we would not get our mail at all. Finally, I spoke to an influential local individual about our

⁷ Contract law has many facets and is further complicated by the fact that contracts can be explicit or implicit; in some situations a handshake can be seen as an implicit contract. In a low context culture like China is, the implicit element is very important and determines what people will do in what situation, and why (or why not) they will fulfill a requirement.

problem. He informed me that to get the mail delivered on time, my company needed to subscribe to several local and regional newspapers. When I asked why I was told that this bureau was also in the publishing business and we needed to be customers of their newspapers first. So now we subscribe to multiple daily and weekly publications so we can get our mail delivered.

Several of our interview subjects also reported that simple interactions with the government or distributors were complicated by China's lack of contract law and convention. Convincing distributors to carry out their end of an agreement can be challenging if formal contract law is not present in the foreign firm's location as well as the distributors. Therefore, firms without the proper *guanxi* or connections need to set about building them or more likely, acquiring them. This can be done by hiring individuals with local influence (Ahlstrom, Bruton and Lui, 2000) or allying with influential local firms (Ahlstrom and Bruton, 2002). These middlemen function as "contract facilitators" not unlike the role played by the guarantors that are still common in Chinese commercial culture (Jenner, 1992; Chen, 2001). Additionally, the managers and legal experts we interviewed were careful to point out that in spite of problems with the rule of law and the need for *guanxi*, firms should not attempt to do business in China without formal contracts. Trust and connections remain important, but firms also need to specify clearly what is expected of both parties.

China's transition toward a market economy and the devolution of authority to local levels has provided ample opportunities for individuals and firms to utilize social capital such as *guanxi* (Boisot and Child, 1988, 1996; Peng and Luo, 2000) to influence court officers, government officials, and other influential individuals. Foreign firms need to be aware of these practices and may need to ally themselves with influential individuals or firms to try to avoid opportunistic actions.

• Discussion

China has a number of well-established institutional elements that can be traced to its long history and rich culture, but formal institutions such as codified laws and case precedent were not parts of the institutional fabric (Jenner, 1992; Tuchman, 1971). In addition, certain normative and cultural elements and taken-for-granted

conventions complicate doing business in China, as evidenced by the heavy reliance on relationships, the low level of trust in the society, and lack of respect for the formal rule of law (Fukuyama, 1995).

While trust building, connections, and alliances with key individuals and organizations remain important, firms should not attempt to do business in China without formal contracts. One consultant argued that this was similar to managing human resources in China, where foreign firms need to carefully explain exactly what is expected of local employees, including as many details as possible (Bruton, Ahlstrom and Chan, 2000). Similarly, when doing business in China with new business partners, contracts need to spell out each party's obligations as carefully as possible. The recommendation often given to foreign firms in the past to "leave your lawyers behind when coming to China" is probably not a good one.

China's legal system still needs considerable reform; commercial and civil law are in the very earliest stages of development (Jenner, 1992; Peerenboom, 2001). Reforms undertaken to date vary greatly around the country and even among industrial sectors. Considerable ambiguity remains over property rights, the limits of the ability of government officials to impose rules and extract fees, and the protection of private firms. Reports of do-it-yourself approaches to solving commercial problems are still too common. Examples provided in our interviews include using force to seize a competitor's assets, taking over their land or buildings, and seeking vendettas on wayward business partners. The WTO means that China will have to accept exogenous approaches to building its commercial law and strengthening criminal law and enforcement to avoid many of the problems firms are currently reporting (Panitchpakdi and Clifford, 2001). More lawyers and judges need to be trained; some estimate that China will need two million new lawyers alone in the coming years (Becker, 2000). The courts will need the authority to adjudicate commercial cases without fear of interference by powerful officials. Society in China must come to believe that the law can work and must be followed, though this will take time.

Even though the overwhelming majority of commercial disputes will presumably continue to be resolved by mediation and private deals out of court, a framework of commercial law is

needed to facilitate such informal processes. Much has been done in recent years, but much is still unresolved. If the central government fails to provide adequate legal institutions to regulate commercial environment, localities may develop their own informal legal arrangements, as may some larger firms. According to our research, China is still a long way from having a legal regime or a judiciary that is largely independent of political influence and capable of regulating commerce with minimal disruption, though certain cities and special economic zones in China have made much progress in this area.

China's institutional environment has implications for managers of foreign firms because it greatly affects the way they do business (Peng, 2000; Pincus and Belohlav, 1996). Many firms and investors do not completely comprehend the unusual institutional and legal structures enveloping the Chinese commercial environment. The large numbers of foreign firms entering China for the first time must understand the legal environment, especially in parts of the country with less commercial tradition and few formal rules governing firms and business transactions.

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Note: This article explores in more detail themes raised in the authors' previous study published in the winter 2003 issue of the *SAM Journal*.

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