Political Governance of the firm-government relations: Evidence from foreign firms in China

Xueyuan Zhang

Rotterdam School of Management (RSM)
Erasmus Research Institute of Management (ERIM)
Erasmus University Rotterdam

Burg. Oudlaan 50, Room T8-50
3062PA, Rotterdam
The Netherlands
Tel: +31 10 4081922
Fax: +31 10 4089015
Email: xzhang@rsm.nl

Abstract

Government is the key actor that foreign firms have to deal with in the institutional environment, and thus political governance is crucial to their operation. The paper explores the organizational choice of foreign firms in China regarding their relationship with local governments. Taking insides from the concepts of transaction cost economics, resource dependence theory, and inter-organizational theory, the paper shows that foreign firms develop a partnership with local governments in China. In transition economies like China, transaction costs involved are more associated with policy ambiguity and enforcement, and governmental interventions in operation. By developing a partnership, foreign firms capture political resources and therefore the cooperative rents, i.e. preferential treatments, insider information, and reduced interventions. The paper also shows that the partnership is governed mostly by both commitments and social networks. Both instruments are complementary and their weights change over time. In addition, the partnership entails costs of time for building up and maintaining the relationship and social contributions requested. Therefore, foreign firms attempt to develop a loose partnership as a tradeoff over time. This further implies how foreign firms develop or adapt their organizational choices in a different institutional environment.

1. Introduction

Government matters in business (Ring, et al. 2005). In international business, host country governments require much attention of MNCs since governments are in control of resources and opportunities that shape their business and institutional environment (e.g. Baron, 1995; Child and Tse, 2001; Makino et al. 2004). The strategic relationship between MNCs (or, more generally, their subsidiaries) and host government is "resurfacing as a critical yet complex issue attracting the attention of both academics and practitioners" (Luo 2001). In practice, however, few firms manage their relationships with governments strategically (e.g. Watkins, 2003). This paper explores the dialectical nature of strategic relationships of MNCs with host-governments in transition economies.

Traditionally, the relationship was regarded as adversarial and confrontational, entailing the bargaining between MNCs and the host governments of developing economies (e.g. de la Torre, 1981; Fagre and Wells, 1982; Kobrin, 1987; Vernon, 1971). Both parties involved in negotiations on entry, operations and exits (e.g. Ramamurti, 2001). Under the pressure of global integration and the competition for FDI, the host governments have gradually shifted their attitudes towards non-adversarial and cooperative relationships (e.g. Dunning, 1998; Vernon, 1998). This shift reflects the acknowledgment of interdependence of MNCs and host governments (e.g. Dicken, 2003; Stopford, 1994). They can be best regarded as 'partners' in economic development (Dunning, 1998). The bargaining approach is focused on the conflicts among them, and thus is not sufficient to interpret their cooperation. Luo (2001) argues building a cooperative relationship with the host governments requires MNCs to adapt to local economic demands and institutional context, obtain external legitimacy and institutional attachment (embeddedness) in operation. However, what is so far less addressed is the underlying process by which MNCs strategize their relationship with host governments.

It requires understanding why and how MNCs govern their relationship with host governments (e.g. Boddewyn and Brewer, 1994). Insights can be borrowed from transaction cost theory (TCT) and resource-based view (RBV). On the one hand, the relationship with host governments can be regarded as the issue of (political) governance established to mitigate transaction costs caused by political risks in the context (e.g. Henisz, 2000; Henisz and Williamson 1999; Henisz and Zelner, 2004). On the other hand, MNCs need to possess or develop capabilities to manage the relationship or institutional idiosyncrasies (e.g. Henisz, 2003; Oliver, 1997). In addition, studies on political strategies, drawing on resource-dependence theory (RDT), inter-organizational theory (IOT) and institutional theory (IT), provide extra insights into the issue. These studies explain that MNCs may have to collaborate with host governments in order to seize control over political resources, conform to institutional pressures, or commit to relational embeddedness. By doing so, firms have to develop means to influence the public policy or the institutional environment (e.g. Andersson et al. 2002; Bonardi and Keim, 2005; Rugman, 1998) and thus to reduce political uncertainty (e.g. Blumentritt, 2003; Blumentritt and Nigh, 2002; Hillman and Wan, 2005). In this sense, the lenses of political governance and political strategy tend to converge.

The purpose of this paper is twofold. First, we seek to provide a deeper theoretical basis for understanding the relationship between MNCs and the host government, one integrating insights from transaction cost theory, strategy theory (e.g. RBV) and organization theory (e.g. RDT, IT, and IOT). Second, in linking political governance and political strategies to the relationship of MNCs and the host government, we seek to extend and enrich current understanding of political governance and political strategies. We do so by distinguishing the underlying mechanism into incentives, constraints, structure. and instruments and capabilities. This enables to understand how MNCs govern their relationship with the government in adapting to the institutional environment.

We illustrate our understanding in the context of China. China has become one of the most favorite destinations of FDI since 1978. It is well known that the government in China plays a significant role in the economy (e.g. EIU, 2003; OECD, 2005), and in the entry and operation of foreign MNCs (e.g. Child and Tse, 2001; Luo, 2002; Peng, 2003). In other words, uncertainty and (formal or informal) government interference characterize the institutional environment in China, and how foreign MNCs manage the government relationship effectively is assumed to be crucial to their operation (e.g. Sanyal and Guvenli, 2000). Therefore, China provides us a rich context to explore this issue. However, very few studies were reported for in China so far (e.g. Luo, 2001; Osland and Björkman, 1998; Peng, 2000; Sanyal and Guvenli, 2000), yet the underlying mechanism of the relationship needs to be formulated.

We conducted a case study in 2004 in China. Our findings suggest that the cooperative relationship with *local* governments in China is crucial for MNCs. MNCs mimetic domestic firms in the way to collaborate with local governments, via formal alliance and informal guanxi, in order to capture political resources to mitigate the uncertainty. Our cases further illustrate that MNCs with strong technological and access to crucial networks enjoy advantages over others in developing the cooperative relationships. In addition, notwithstanding the importance of informal networks in emerging markets, MNCs maintain distance in the cooperation, especially at the informal level, in order to minimize the costs. The most successful firms integrate their need for informal relationships with effective relationship management.

These findings suggest that local institutions (such as local governments), instead of national institutions, should be paid more attention in international business. The study brings political strategies and political governance together, enriching our understanding of the relationship between MNCs and the host government. In integrating insights from different streams of disciplines, we explore the potential value of context-based, interdisciplinary study in the international business, which echoes to the calling in the field (e.g. Meyer and Peng, 2005; Shenkar, 2004; Tsui, 2004), and further enriches our understanding of organizational behavour under certain context (e.g. Johns, 2006). Practically, the findings illustrate how MNCs should optimize their relationship with the host governments in transition economies like China.

The remaining of the paper is organized as follows: In section 2, a theoretical framework is formulated based on insights from various perspectives. In section 3, research methods are introduced. It is, in section 4, followed by the description of findings. Section 5 provides discussions and propositions. Section 6 concludes the paper.

2. Theoretical background

Drawing on the advance in studies on political strategies and political governance, we take insights from TCT, RBV, RDT, IOT, and IT, and develop a conceptual framework for exploring the MNC-government relationship. The underlying mechanism need to be formulated by examining its governance and its underlying incentives, constraints, and firm capabilities.

2.1 Structures of political governance

What structure do foreign MNCs decide on their relationship with the host government when facing the uncertainty in the political domain? While studies on political strategies point to lobbying and influence strategies, transaction cost theory emphasizes the choices among different strategies. The traditional focus of transaction cost theory is on the relationship between two economic agents, i.e. to what degree one should integrate the transactions with the other regarding associated transaction costs originated from asset specificity and opportunism (Williamson, 1985). Transaction cost politics shifts the focus to the relationship between private investors with the government, arguing that private investors should govern this relationship by appropriate strategies to mitigate political hazards (Henisz and Williamson, 1999).

Political hazards are greatest in emerging or transition economies where enforcement of economic institutions is weak and institutions involve rapid changes and ambiguity (e.g. Henisz and Zelner, 2004; Luo, 2006). Official arbitrary and intervention increase the hazards. Transaction cost politics argues that political hazards directly create transaction costs around the business, as defined by North (1990), and hence a choice of political governance helps MNCs to (partly) internalize political hazards, in which to actively shape their own institutional environment (e.g. Haslam, 2004; Henisz and Williamson, 1999; Henisz and Zelner, 2004). Henisz and Zelner (2004) propose that MNCs tend to use lobbying, instead of general political mechanism, when political hazards are high. De Figueredo and Kim (2004) argue that firms tend to use employees (integration), instead of external groups, for lobbying when it involves firm-specific information. From a structural perspective, we assume that lobbying by employees is analogue to alliance while general political mechanism is analogue to spontaneous market.

2.2 Incentives and political resource

First of all, it is crucial to understand why MNCs wish to develop a cooperative relationship with the host government. The resource-dependence theory argues that organizations rely upon the external environment to provide resources and support for their survival (Pfeffer and Salancik, 1978). Therefore, the survival of firms needs to sort out key stakeholders in the environment and strategize the relationship with them in order to capture the critical external resources (e.g. Casciaro and Piskorski, 2005; Frooman, 1999; Mathews, 2003). Strategizing for external resources considers not only market factors such as technology, but also nonmarket factors including social, political, and legal resources controlled by governments and public institutions. It is argued that the latter is fundamental to firms' survival (e.g. Baron, 1995; Oliver, 1997; Pfeffer and Salancik, 1978).

The institutional environment often provides an attractive political market where firms seek to influence government policies and obtain an advantage (e.g. Bonardi and Keim, 2005; Bonardi et al. 2005; Gets, 1995; Schuler et al. 2002; Shaffer and Hillman, 2000). Studies on MNCs' political strategies recognize the significance of the political behaviour of host governments in post-entry operation (e.g. Blumentritt, 2003; Blumentritt and Nigh, 2002; Hillman and Wan, 2005). MNCs do not only have to negotiate with host governments regarding initial entry and the distribution of economic rents (e.g. Vernon, 1971), but have also to manage the institutional distance or idiosyncrasies strategically in the operation stage (e.g. Caves, 1996; Henisz, 2003). In other words, MNCs need to develop an appropriate relationship with the host government to exert influence on government policies in the host country (e.g. Boddewyn and Brewer, 1994; Rugman, 1998). To do so, the behavour of the host government must be taken to the core of analysis. It is particularly important in emerging or transition economies where governments exert considerable influence over firms not only, and governmental policies are much more variable as well (e.g. Luo, 2002; Makino et al. 2004; Ramamurti, 2003).

Therefore, MNCs have incentives to strategize their relationship with the host government. Building a good relationship can help MNCs to capture political resources controlled by the government or gain assistance of the government, which eventually mitigates the uncertainty of the environment and smooth their operation.

2.3 Constraints and institutional pressures

How MNCs behave in or react to the institutional environment in the host country is highly constrained to the requirement for external legitimacy. Institutional theory predicts that firms' activities tend to conform with predominant regulations, norms and routines in the social, political context where they operate (DiMaggio and Powell, 1983, 1991). These norms and routines generate social pressures for firms. The conformity with these pressures provides firms with legitimacy for their survival (e.g. Deephouse, 1996; Suchman, 1995).

Countries differ with each other in terms of cultural, political and institutional systems. These differences have significant influence on the behavour of foreign MNCs in a host country (e.g. Khanna et al. 2005; Kogut and Singh, 1988). Studies on political strategies have confirmed that firms tend to use lobbying or influence strategies in developed economies or US in particular (e.g. Bonardi and Keim, 2005; Bonardi et al. 2005; Gets, 1995; Schuler et al. 2002; Shaffer and Hillman, 2000). However, these activities may not be legitimate in emerging or transition economies.

Studies on China show that decentralization gives rise to a distinct institutional form – network capitalism (e.g. Boisot and Child, 1988, 1996), and that local governments function as local corporatism (Nee, 1992; Oi, 1995; Walder, 1995) in which local governments establish varied networks with economic agents. In this way, local governments expect to capture cooperation rents. To survival, therefore, foreign MNCs *have to* conform to the political norms established around local corporatism, by which they gain external legitimacy regarding local governments' expectations. In addition, under an institutional environment where formal economic institutions are weak and intervention prevails, informal institutions may play an important role in facilitating economic activities (e.g. Boisot and Child, 1996; Meyer and Peng, 2005; Peng and Heath, 1996). Thus, firms tend to access or establish guanxi networks with powerful persons to acquire information and protect against risks for their businesses. This business norm pushes foreign MNCs to develop guanxi networks when approaching to local governments in China.

Studies on Chinese firms show that they widely involve in different kinds of alliances or partnership with local governments, such as the government ownership of township and village enterprises (TVEs), and in close guanxi networking to handle the institutional uncertainty (e.g. Bruton et al. 2000; Che and Qian, 1998; Krug, 2004; Park and Luo, 2001; Peng and Luo, 2000). It can therefore be argued that imitating these local institutionalized practices helps foreign MNCs to increase their external legitimacy which contributes to their survival.

2.4 Organizational capabilities and instruments

How do foreign MNCs govern their relationship with the host government? While transaction cost theory stresses the importance of contracts as governance instruments (e.g. Williamson, 1985), inter-organizational theory extends the instruments including social capital or relational contracts (e.g. Dyer, 1997; Granovetter, 1985;

Nooteboom, 2004; Ring and Van de Ven, 1992). Organizational capability approach argues that firms need to possess power or capabilities to achieve their strategic goals (e.g. Barney, 1991; Peteraf, 1993). In a sense, instruments and capabilities may be overlapping in their contents.

Studies show that the cooperation can survive more likely when foreign MNCs make credible commitment which helps to achieve external legitimacy (e.g. Oliver, 1990) and to keep opportunistic behaviour at bay (e.g. Zaheer and Venkatraman, 1995). In addition, firms often resort to informal, social interactions to maintain their external relations, to carry out contract implementation, and to respond to unforeseen contingencies (e.g. Granovetter, 1985; Nooteboom, 2004). Managerial ties function as a facilitating instrument of managing external networks (e.g. Hillman and Dalziel, 2003; Pfeffer, 1991), channeling resources and exchanging information (e.g. Peng and Luo, 2000; Rao, et al. 2005). To sufficiently govern the relationship, foreign MNCs should be capable of making use of these instruments. Firms differ in their strategic intention and resources (Barney, 1991; Wernerfelt, 1984), their (dynamic) capabilities (Teece et al 1997; Eisenhardt and Martin 2000). Therefore, they differ in capabilities of developing relationships effectively and in their need for specific relationships with host governments. It can be argued that the stronger a firm's capabilities, the more likely they are capable of developing a close relationship with the government.

The above review suggests that how MNCs govern their relationship with the host government depends on external incentives, institutional constraints and organizational capabilities. It is assumed that a cooperative relationship will be developed at both macro and micro level. In the following, we develop a case study to explore the proposed mechanism of the MNC-government relationship in China.

3. Research method

3.1 Designing of the research

To unpack the issue of the relationship of foreign MNCs with the host governments, we need to obtain detailed information on events, incentives, and means, which can be not fulfilled by standard econometric analysis. Therefore, we develop a multiple-case study in China to fulfill our goal, which is most suitable for studies with the exploring feature (Eisenhardt, 1989; Yin, 2003), particularly for those strategic issues in emerging economies (e.g. Frynas et al. 2006; Hoskisson et al. 2000; London and Hart, 2004)

We select China as the context of this study based on two reasons. First, China has been one of the most attractive destinations for FDI. In 2004 only, China attracted FDI inflows of more than 60 billion US dollar surpassed only by the United States and the UK, which outperformed other transition or emerging economies (UNCTAD, 2005). As a consequence, more than five hundred thousand foreign invested enterprises have been established in China (China MOC, 2005). Second, the institutional environment has long been criticized as uncertain, which is mostly caused by policy ambiguity and government intervention. Government intervention has shifted from entry screening to operational interference (e.g. Luo, 2002). The paradox of uncertain institutional environment on the one side and the amazingly increasing number of foreign invested enterprises on the other suggests that foreign MNCs must have found effective ways to get along with the host government and thus move these obstacles "away". It makes conducting the study in China very attractive.

3.2 Unit of analysis and case selection

Studies on political governance or strategies often take firms as unit of analysis because they are the organs that have direct interaction with the government (e.g. Bonardi and Keim, 2005). However, the organization of MNCs makes it necessary to distinguish between MNCs as a corporate and their subsidiaries. A subsidiary abroad is not perfectly integrated with the parent firm, but partly independent of the parent firm (Ghemawat, 2003). Characteristics of a subsidiary play a crucial role in the MNC's interaction with the host government. Yet, there are few studies exploring political strategies of MNC subsidiaries (e.g. Blumentritt and Nigh, 2002; Hillman and Wan, 2005). Therefore, we take MNC subsidiaries (or foreign invested enterprises) as unit of analysis, which can enhance our understanding of the phenomenon understudied.

The foreign invested enterprises (FIEs) in our study are selected on theoretical sampling (Eisenhardt, 1989; Yin, 2003). Thus, we seek samples that can fulfill the goal of theory building. In the selection, we consider also factors such as ownership, country of origin, industry and size, the resulting samples of which can better represent the diversity of FIEs in China. Table 1 summarizes the profiles of 12 FIEs selected for the case study. These 12 FIEs invest in seven different industries in manufacturing, come from nice different countries of origin, and demonstrate diversity in size and ownership. There were founded in different years from 1992 to 2004.

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Insert Table 1 about here

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3.3 Data collection

Data were collected by conducting semi-structured interviews. Interviews are a valid instrument to learn about motives, constraints and the decision making process

(Bewley, 2002). The semi-structured interviews follow a pre-designed protocol but allow for new questions to emerge as the interviews progress (Malhotra, 2003). We sought to interview top managers who are knowledgeable enough about the relationship with the host government. In addition, we interviewed also six government officials in order to get "the other side of the story" (Peng, 2000).

The study was conducted in the period of September to November 2004. We conducted all interviews during on-site visits to every firm and government office. Confidentiality was ensured to the firms and individuals. Interviews typically lasted 60 to 120 minutes. Two or more interviewers conducted all interviews, recorded notes for each interview with the permission of interviewees, and transcribed these ultimately developing a single report per interview later in the same day. The accuracy of the interview data was thus assured by timely transcription and member checks.

4. Findings

In the following we report the findings from 12 FIEs in China regarding their relationship with the host government. These data demonstrate that (1) foreign subsidiaries develop a cooperative relationship with the *local* government in China, which is beneficial to their performance; (2) In doing so, foreign subsidiaries seek political resources that help them to work around policies and interventions; (3) The behavour of foreign subsidiaries is also constrained by normative pressures in the institutional environment; (4) To do so, foreign subsidiaries need to possess or develop technical and non-technical capabilities; and (5) the relationship between foreign subsidiaries and the local government is formulated at both macro and micro level, but they attempt to keep distance at the micro level in order to reduce potential costs embedded.

4.1 Structure and performance of the MNC-host government relationship

When the MNC-host government relationship is addressed, all interviewees from FIEs refer to the relationship with the *local* government, instead of the central government. In their eyes, the local government plays a significant role in their operation. Our cases admitted that the local government has authority in implementing central policies, issuing financial subsidies within the local budget, enforcing economic penalties (such as that on tax-stealing), bridging firms with the upper-level governments, and has resources or capabilities to solve problems firms experience.

All cases mentioned that they have a good relationship with the local government in terms of (1) the government provides good services by thinking on their feet, and (2) the government provides supports or helps when needed, and thus that this good relationship is beneficial to firm performance. In addition, most of them admitted that they have frequent contacts with the government in terms of receiving visits from the government or participating activities (e.g. business forum or festival celebrations) organized by the government. This good relationship refers to collaboration or alliance, as reflected in the comments by Case 5 and 9:

> *"We have close relationship with the government. It is reflected in our close cooperation." (Case 5)*
>
> *"We coexist for mutual benefits. We do not have competition for benefits, but only collaboration." (Case 9)*

On the other side of the relationship, local government officials also consider there is cooperative relationship between the government and FIEs. It is echoed by the clear statement of one official interviewed: "It is a collaborative relationship. The government does not intervene with firms' operation, but helps them to solve problems.

The collaborative relationship is regarded as significant for a firm. All cases interviewed admitted that it is beneficial to the firm's operation and survival in an environment where the legal framework is not perfect yet and economic institutions are weak. As Case 5 stressed, it smoothes the bureaucratic process and provides flexible treatments regarding policies and regulations.

4.2 External incentives

When asked why it is necessary to maintain a good relationship with the government, one case clearly stated that it depends on the behavour of the government. It is very necessary when the behaviour of the government is not enforceable and policies and regulations are ambiguous. Our cases reveal that aspects of both policy and intervention formulate the external incentives for FIEs to develop a good relationship with the government.

First of all, our cases reported that one problem of operating in China is that policies change often and quickly, which is confirmed also by some officials. It leaves hidden things for firms to explore. One significant aspect is negotiating policies. Our cases reflected that some regulations are negotiable at the local level, such as land price, local tax and fees, and financial subsidies etc. In doing so, firms may obtain land at a lower-than-market price, reduced or waived local tax and fees, or additional financial incentives. For example, case 4 admitted that they obtained a flexible treatment of building employee dormitory on the factory which is usually not allowed; Case 8 reported that they received a refund of property tax; Case 10 received extra tax reductions beyond those standard specifications by the central policies.

In order to negotiate better policies, our cases show that it is necessary to have a good relationship with the local government. It can be reflected in supports FIEs can expect from the government. Two cases reported that they sought help from the local government when they were unclear about some policy issues. The local government helped them not only interpret the policies, but also find appropriate policies to get preferential treatments by communicating with the upper-level government. For example, Case 2 obtained additional quota of importing raw materials from the provincial government with the help of the local government. More benefits of cooperating with the local government are related with local regulations. Case 1 reported that they sought support from the local government when they faced the local transportation regulation which restricted those heavy transportations over daytime. Case 3 received help from the local government when requesting loans from banks. Case 8, 9 and 12 sought help from the local government for the electricity supply when there was shortage of power supply in the summer. These cases admitted that a good government relationship facilitates them to channel their concerns on policies or regulations to the government, and talk them by setting up formal or informal meetings.

Second, our cases also reported that they experienced various interventions from government bureaus, while some of them commented that the intervention becomes less than before. Government interventions take shape differently. Two cases reported that they experienced official interventions. In case 2, the government asked the joint venture to buy out the shares of the Chinese partner when the partner had financial trouble. In Case 5, the government asked for financial compensation due to the money-losing of the joint venture in the first three years. Another two cases show that the government intervention is actually from those functional bureaus. For example, tax offices may come to check a firm's financial problems. In addition, two cases mentioned that they experienced informal interventions which are quite subtle when dealing with. For example, Case 8 provided evidence that some employees from those functional bureaus (such as fire department and public security bureaus) sought their own commercial interests under the guise of official identities. They often come to check whether related facilities meet the requirement, and then propose improving or updating with facilities they can provide.

In order to deal with formal or informal government intervention, our cases admitted, they also need to develop a good relationship with the local government. It facilitates them to negotiate with the government. For example, officials from tax offices confirmed that FIEs, when receiving penalties due to for example tax stealing, often make use of their good relationship with the government officials for negotiation. Similarly when they face informal intervention such as in Case 8, the firm reported what happened to the government and the government helped to resolve these problems.

Therefore, FIEs operating at the local level in China, face various policy issues and interventions. Our cases confirm that FIEs need to develop a good relationship with the local government to retain or negotiate on better (local) policies and mitigate or avoid various interventions.

4.3 Institutional pressures and legitimacy

Our cases confirm further that they have to get along with the local government in a sense because they involve and are embedded in the local game. It is determined by the normative pressures FIEs experience, as reflected in the behavour of the local government and the utilization of personal relations (guanxi).

First, the local government often demonstrates enthusiasm in the operation of (foreign) firms. On the one hand, the government is happy to see the prospering of FIEs, and on the other hand, the government also expects their contribution to the local in one way or another. All cases confirm that they have frequent contacts with the government, it includes both formal visits from the government, or meetings with officials. Six cases stress that the government often organizes visits to firms that have a good performance or an identity of technology advance. As admitted by Case 9 and 10, it costs lots of effort and time to arrange their visits and present the firm for them, which is kind of burden, but the cooperation enables them to obtain legitimacy and facilitates to access to and talk with officials frankly. In addition, the government often invites similar kinds of firms to have an economic forum or consulting meetings in which firms can express their concerns and provide advices for the government on the business environment, as confirmed by Case 9 and 10. Facing this kind of behavour of the government, the best strategy of firms is to cooperate.

Second, the government may request FIEs to contribute to some (non)commercial activities organized by the government. As admitted by Case 8, they didn't like the compulsory kind of sponsorship to for example publishing books by the government, but had to make compromise. Experiencing such events, as commented by Case 6, the firm should show the cooperation and "give a face to the government". However, our cases also admitted that they often voluntarily make donations to education or develop other social activities. These activities include donations to the regions suffering natural disasters, donations to Hope Project and university scholarship, and organizing cleaning services in tourist resorts, etc. These activities help them to develop credits in the society and achieve legitimacy from the government.

Third, our cases confirm that personal relations (guanxi) prevail in the interaction with the government. Due to its embeddedness, it is not realistic to avoid it, as commented by Case 12. The personal relations that firm managers have with officials in a crucial position facilitate the operation of firms. As interviews with officials reveal that, once firms have conflicts with the government bureaus, the personal relations often provide moderating role in solving problems, which is more effective than formal channels. For example, Case 9 confirms that they, when suffering electricity shortage, can easily channel their concern to the government through their personal contacts with officials in various occasions.

In sum, our cases confirm that their engagement in the cooperation with the local government is partly due to the pressures created by the local government who seeks participation of firms in their activities. The pressures push firms to conform, at least partly, to the requirement or expectation of the government. In addition, norms associated with personal relations also require firms to do so.

4.4 Organizational capabilities and instruments

What helps FIEs to develop and maintain the cooperative relationship with the government? All cases agree that the relationship is developed over time. In the process, many factors play a role. Our cases point to factors such as firm commitment or performance, personal relations, participation in activities organized by the government, and firm actions.

First, firm commitment or performance is one of the most often considered factors. Interviewees confirm that those FIEs that are willing to commit to, for example, long-term investment and technology transfer, and those with good economic performance or considerable significance to the local economy (e.g. big tax payer, famous brand, favorite projects, and advanced technology) are more likely to attract the government attention that leads to a good or cooperative relationship. As Case 2, 9 and 10 commented, the local government regards that these firms contribute to the local economic development, and further their success will bring more FDI in.

Second, the development and maintenance of the relationship needs participation of firms in official forums or celebrations, or cooperation with the government when requested for visits. As Case 2, 8 and 9 reported, the good relationship is developed over time through their contacts and interactions. The invitation of the government to those activities demonstrates the attitude of the government towards the firm. Through these formal channels, firms get chance to know the government and officials well gradually, and enable them to express their concerns and receive tacit information about doing business at the local level.

Third, the good relationship with the government also relies on firms' actions, which is related participation but worthy stressing separately. Four cases mentioned that it is important to "give the government a face" once there are invitations or visits from the government, or conflicts with the government. This kind of behaviour helps to develop a "mutual understanding" between them to avoid potential conflicts, and thus helps to maintain a good relationship. As in Case 6 and 8, the interviewees reported that, when they had conflicts with functional bureaus, they sought help from the government on the one hand, and invited those bureaus for negotiations through which both parties make compromise. Case 4 mentioned that they took proactive actions in order to avoid interventions and develop a good relationship with the government and those functional bureaus. The firm, together with a few other FIEs, donated a fire engine to the local fire department.

Fourth, personal relations are important to building a good relationship with the government, as confirmed by our cases. Case 2 stated that "the good relationship with the government is developed out of the close personal relations between the top managers and government officials". Case 4 further pointed out that "the maintenance of a good relationship with the government needs the take-and-give reciprocity embedded in personal relations". Other cases also confirm that personal relations play a significant role in facilitating the information exchange between the firm and the government.

4.5 Distance in the governance relationship

The above description reveals that the MNC-host government relationship is structured at both macro level and micro level, i.e. organizational collaboration and individual guanxi networks. Our cases demonstrate that a good relationship needs to be maintained at distance, especially at the micro level.

The most revealing statement is provided by Case 4: "there coexist benefits and costs of personal relations in maintaining the relationship with the government. The firm wishes to grow through personal relations which help to develop a good relationship with the government and attract attention from the government. But, the more the firm grow, the more attention it received from the government. This growing attention may lead to more requirements from the government such as donations to all different activities organized by the government".

The embedded costs of personal relations, as pointed out by our cases, also include personal requests from officials (such as arranging jobs for their relatives) and time costing to meet them and maintain the relations, etc. Some cases stressed that they have good personal relations with officials, but they don't spend much time to maintain a very close relations on purpose. As Case 8 pointed out, "we were cautious to develop too close personal relations" in order to avoid intervention.

Therefore, it appears that FIEs attempt to develop a good relationship that can keep distance from each other. In doing so, FIEs can reach a better balance of benefits and costs of a close relationship.

4.6 Summary

What so far has been described provides details on how FIEs govern their relationship with the host government in China. These evidences verify the applicability of the proposed framework, in which we argue that the strategy that FIEs develop a cooperative relationship with the host government is to seek political resources, to reduce uncertainty by conforming to institutional pressures, and is maintained by organizational capabilities. The building blocks of the framework can be further elaborated as in Figure 1.

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Insert Figure 1 about here

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First, FIEs attempt to develop collaboration with the *local* government, which is different lobbying and spontaneous bargaining. This collaboration is maintained at both macro and micro level, i.e. organizational collaboration and interpersonal networks. It appears that both levels are interlinked closely. However, a close interpersonal network involves costs. Our cases show that they attempt to capture benefits of collaboration while keeping distance at the micro level in order to mitigate the costs involved as much as possible.

The incentives for foreign subsidiaries to do are political resources that help to ensure or enforce policies, and to reduce or avoid interventions. At the local level, FIEs are intended to influencing not the policy making but the policy (re-)interpretation or implementation. Therefore, the incentive is from possibilities of negotiating favorite policies. In addition, government interventions include not only the requirements imposed by the government on firms regarding their operation, but more often the interference of functional bureaus of the government and informal interference made by government personnel.

The behaviour of foreign subsidiaries is constrained by political or business norms embedded at the local level of the business environment. On the one hand, the local government expects the participation of foreign subsidiaries in their activities, including those platforms where they exchange opinions with the government, and also those (non)commercial activities in which foreign subsidiaries are reluctant to contribute. Conforming to these norms provides them external legitimacy. On the other hand, the informal institutions, guanxi networks, prevail in business activities. It requires foreign subsidiaries to make use of these networks to channel their concerns to the government effectively.

Furthermore, foreign subsidiaries need to possess capabilities or develop instruments to build up and maintain a cooperative relationship with the local government. Their commitment to long-term investment and technology transfer is crucial starting conditions. Related to it are heir capabilities such as big brand and advanced technologies. In addition, foreign subsidiaries that are large in terms of size or economic significance to the local are also capable of developing a good relationship with the government. Beyond the economic means, foreign subsidiaries should take actions in participating in the political domain such as in activities organized by the government and those that meet interests of local officials. At last, foreign subsidiaries should have or develop guanxi networks (interpersonal relations) with officials, which are necessary capabilities of getting along with the government.

To conclude, seeking political resource, institutional constraints and organizational capabilities define the underlying mechanism of foreign subsidiaries' political governance regarding the relationship with the host government. The mechanism is shaped by external incentives and constraints, and internal capabilities, which are all context-specific.

5. Discussion and propositions

Our cases reveal that managing the strategic relationship with the host government requires foreign MNCs carefully examining the context in which they operate and deciding what they should do and what they can do. It lends insights from different perspectives which each focus on one aspect of the issue and together leads to an integrative framework of analysis. This framework needs to be further discussed in order to better understand this strategizing process in a context. In the following, we bring our findings with the recent theoretical development together into tentative propositions.

5.1 Matching of the players

Previous studies addressing the relationship of MNCs with the host government often take the host government as a whole or take the national government at the core. Few have recognized the importance of the local governments (e.g. Clissold, 2004). Recently, sub-national institutions are called for attention to in strategizing in transition economies (e.g. Meyer and Ngyuen 2005). In China, the significance of local governments has gradually been recognized for the successful operation of foreign MNCs. Peng (2000) demonstrates that collaborating with the local government enables foreign MNCs to benefit from the policy implementation. Osland & Björkman (1998) and Sanyal & Guventi (2000) stress that foreign MNCs should develop good relations with officials at national, provincial and local levels. These studies however do not consider the effect of organization of MNCs.

Recent studies of political strategies in international business found out that taking MNC as whole is not sufficient when considering their political activities in the host country (e.g. Blumentritt and Nigh 2002; Hillman and Wan, 2005). These studies point out that the interaction of MNCs with the host government is localized game which relies on their subsidiaries and the characteristics of the host country.

It seems to suggest that the relationship of foreign MNCs with the host government is developed at different levels. At the corporate level, foreign MNCs or their regional headquarter interact directly with the national government, and at the subsidiary level, foreign subsidiaries interact with the local government. Our findings strongly support this prediction. In China, local governments, as a consequence of decentralization, have autonomy in implementing the central policies and authority in managing local economy. All of our cases, which are foreign subsidiaries, report that their government relations are concerned directly with the local government. By doing so, they mitigate both policy uncertainty and government interventions. Therefore, it can be argued that foreign MNCs need to develop a player-match at two levels in a host country.

> **Proposition 1a**: If local governments are more active in the economy of the host country, the demand is higher that foreign MNCs strategically manage their relationship with the local governments.
>
> **Proposition 1b**: If a foreign subsidiary is more localized, the subsidiary is more active in managing its relationship with the local government.

5.2 Context-specific incentives

Managing the relationship with the host government is to reduce the uncertainty in the context where foreign MNCs operate. Previous studies on political strategies and political governance argue that firms attempt to influence the formulation of policies in order to reduce the uncertainty caused by regulatory changes, by which firms capture political resources on the one hand (e.g. Bonardi and Keim 2005; Frynas et al. 2006) and govern expected political hazards successfully on the other hand (e.g.

Henisz and Williamson, 1999; Henisz and Zelner, 2004). Most of these studies are developed in Western developed countries, especially in the US. When it is extended to other economies, the same or similar framework is applied, which thus dismisses the contextualization of the problem. Recently, studies on political strategies have been extended to foreign subsidiaries in the host country (e.g. Blumentritt and Nigh 2002; Hillman and Wan, 2005). Such an extension needs to examine the specific context of host countries (e.g. London and Hart, 2004; Meyer, 2004; Shenkar, 2004).

In different contexts, foreign subsidiaries may be confronted with different policy or regulatory issues that cause uncertainty. Foreign MNCs must be capable of managing this institutional complexity (Henisz, 2003). Even in a context, subsidiaries may be confronted with more issues than policies that shape their business context. Brasher and Lowery (2006) demonstrates the context within which firms operate is of diversity and this diversity plays a large role in influencing political activities of firms. Our findings confirm that foreign subsidiaries are confronted not only with policy uncertainty but also with various interventions that may threaten their operation. These interventions can be regarded as the feature of transition economies, as the enterprise survey of World Bank (2005) reveals. In transition, the institutional environment is subject to improving and (local) governments actively involve in economic activities of firms. In addition, functional bureaus and even officials may have different interests from the government. As our cases show, these interventions, together with policy uncertainty, formulate higher incentives for foreign subsidiaries to strategically manage their relationship with the government. Makino et al (2004) confirm that governments matter more in transition economies where the institutional environment is weak. Therefore, it can be suggested that:

Proposition 2a: Foreign subsidiaries have higher incentives to strategize their relationship with the host government in transition economies than in developed economies.

Proposition 2b: In transition economies, incentives of the political strategy of foreign subsidiaries are not only to enact to policies but also to work around interventions.

5.3 Legitimacy as political strategy

Most of studies on political strategies are built on insights from resource-dependence theory arguing that firms seek to capture political resources controlled by external organizations. This tradition of studying downplays constraining aspect while stressing incentive aspect of the same coin. Institutional theory highlights constraints of the context on the behavioural choices of firms and is proved to be rich in understanding strategies of foreign MNCs in a host country (Kostova and Zaheer, 1999; Rosenzweig and Singh, 1991; Xu and Shenkar, 2002). In the context of a host country, foreign MNCs need to develop external legitimacy by which their actions are regarded as desirable by other crucial organizations in the context. This legitimacy demand is high when foreign MNCs seek active support of these organizations (e.g. Hillman and Wan, 2005; Suchman, 1995).

Hillman and Wan (2005) examine political strategies of foreign subsidiaries relying on institutional theory. They conceptually distinct three political strategies: information strategy, financial incentive strategy, and constituency-building strategy. These three strategies differ from each other in terms of targets and goods provided, which address their incentives but not behavioural constraints. In addition, when they examine determinants of applying certain political strategies to achieve legitimacy, they attempt to examine features of foreign MNCs such as duration of operation, size, and international experience which determine their demand for the legitimacy. When they examine the institutional context, they simply conceptualize it as political structures of corporatism or pluralism. The larger part of the details is simplified out. Our findings show that, indeed, the political structure of corporatism at the local level in China influences political strategies of foreign subsidiaries there. Our findings further reveal that it is not the political structure itself but the (formal or informal) behavioural norms constructed within the system that determine how foreign subsidiaries may get along with the host government. Conforming to these norms enables or facilitates foreign subsidiaries to carry out their political strategies. Therefore, it can be argued as follows:

> **Proposition 3**: In transition economies, foreign subsidiaries are more likely to carry out their political strategies successfully when they achieve legitimacy to formal or informal norms constructed within the business relations in the context.

5.4 Organizational capabilities and governance

Organizational capabilities and transaction cost economics are complementary to each other in understanding collaboration (e.g. Madhok, 1997; Williamson, 1999; Zajac and Olsen, 1993). Transaction cost economics argues that the relationship needs to be governed by certain instruments. The instruments of governance have a broad range of choices, including contracts, trust, go-betweens, and network position, etc (Nooteboom, 2004). These instruments reflect organizational capabilities in one way or another. For example, trustworthiness (Barney and Hansen, 1994) and guanxi networks (Tsang, 1998) are proved to be important capabilities of firms to strategizing. Network position can be understood as both commitment and economic significance to the other party in collaboration. Therefore, from a perspective of strategizing, it is probably more crucial to examine organizational capabilities.

Studies in political strategies often stress external incentives of firms to capture political resources. Empirical studies show that larger firms are more active in capturing political resources (e.g. Brasher and Lowery, 2006; Schuler et al. 2002). It holds for foreign subsidiaries as well, as proved by Hillman and Wan (2005) that subsidiary size is positively associated with their political activities. In these studies, firm size is measured by proxy of revenues.

Our findings extend the measurement of firm profiles beyond size. Our cases reveal that organizational capabilities that matter in political governance include both technical capital such as commitment to long term investment, big brand, size (linking to economic significance to the economy), and social or institutional capital such as personal networks. Luo (2001) confirms that all these capabilities contribute to the development of a cooperative relationship with the host government. Therefore, using firm size as proxy is not sufficient. It can partly represent technical capital at most, but can not represent social or institutional capital. When foreign MNCs operate in transition economies, both kinds of organizational capabilities are necessary. As Frynas et al (2006) demonstrate, interpersonal networks, in combination with technical capabilities, play a significant role to reinforce foreign MNCs' relationship with the host government. Therefore, it can be argued that

> **Proposition 4**: In transition economies, foreign subsidiaries are more successful in managing their cooperative relationship with the host government when they combine both technical capabilities with social capital or personal networks.

5.5 Governance and distance of collaboration

Studies on political governance, relying on transaction cost politics, argue that the degree of political hazards determines what political action (lobbying or bargaining) firms take (e.g. Henisz and Zelker, 2004). Different actions represent different modes of structures among the inter-dependent firm and the government. In this sense, it stresses the governance at the macro (organizational) level. As it is argued by sociologists, the inter-organizational relationships are embedded in social relations (e.g. Granovetter, 1985; Uzzi, 1996). These studies argue that social networks play a significant role in governing the inter-organizational relationship by providing trust and information.

Our findings confirm that the collaboration between foreign subsidiaries and the local government is developed at two levels: macro and micro level. At the macro level, foreign subsidiaries tend to collaborate with the local government to “internalize” political hazards. At the micro level, managers of foreign subsidiaries tend to develop good interpersonal relations (guanxi networks) with officials to reinforce the macro-level collaboration. It is in consistent with what have been found by Peng and Luo (2000) that the inter-organizational relationships in China need to be addressed through a macro-micro link. Other studies on foreign MNCs in China also confirm that guanxi networks with government officials are very crucial to firms’ operation, which provide both trust and information (e.g. Frynas et al. 2006; Osland and Björkman 1998; Sanyal and Guventi, 2000).

While stressing the importance of interpersonal relations, these studies rarely address the cost of maintaining and using interpersonal relations. Few studies have recognized that maintaining guanxi networks involves costs such as time (e.g. Osland and Björkman 1998). Our findings further point out that there are embedded costs in guanxi networks while they empower foreign subsidiaries. These costs include time spending and reciprocal return. To economize on these costs while exploring the values, foreign subsidiaries tend to keep some distance with officials or the government. The underlying logic is similar to learning in interfirm alliance. A trade-off is needed to balance capabilities building and differences among partners in alliance (e.g. Nooteboom, 1999; Wuyts et al. 2005). If foreign subsidiaries or their managers have too close relationships with the government or officials, they become too much embedded into the social networks. It requires more time to spending on network building and foreign subsidiaries may have to fulfill more requirements from the government (officials). Therefore, we argue that there is a tradeoff between capturing political resources and distance of guanxi networks.

> **Proposition 5a**: In transition economies, the collaboration of foreign subsidiaries with the local government involves micro-level interpersonal networks more likely when these networks are more informative than market.
>
> **Proposition 5b**: The benefit of collaboration with the government may have a reverse-U shaped relation with the distance of interpersonal relations.

6. Conclusion

This paper examines how foreign MNCs govern their strategic relationships with the host government in China. In this study, we take foreign subsidiaries as unit of analysis. Our cases reveal that foreign subsidiaries focus their attentions on the local government, instead of the national government. They tend to develop a good cooperative relationship with the local government. The underlying mechanism is shaped by external incentives, behavioural constraints, and organizational capabilities. External incentives are to capture political resources to mitigate political hazards and (formal or informal) interventions at the local level. Their behaviour choices are constrained within the normative systems around the local government and social networks in the local business context. To achieve their goal, foreign subsidiaries need to exploit their capabilities in making commitment, economic performance, and accessing to interpersonal networks.

Our study makes significant contributions to theory building in the MNC-host government relationship in two folds. First, previous studies argue that the relationship is mainly determined by organizational capabilities. The bargaining outcomes rely on their relative bargaining power (e.g. Kobrin, 1987; Moon and Lado, 2000). The cooperative relationship depends on foreign MNCs' capabilities to accommodate with the host government (e.g. Luo, 2001). Our study drawing on insights from political strategy and political governance shows that the cooperative relationship does not rely only on organizational capabilities. The development and maintenance of the relationship is determined also by external political resources or incentives and institutional constraints. All three factors determine how the relationship is formulated and governed. The political components enrich our understanding of this relationship (e.g. Boddewyn and Brewer, 1994). Second, most of previous studies do not consider the organization of MNCs and the structure of the host government. It misses a great deal of the picture. Peng (2000) illustrates the significance of the relationship with local governments in China for foreign MNCs. A few studies recognize the role of foreign subsidiaries in developing political strategies in the host country (e.g. Hillman and Wan, 2005). Our findings stress that foreign subsidiaries mainly strategize their relationship with the local government, which implies that the relationship with the central government is managed by the regional headquarter of MNCs. This layered management of the government relationship extends the previous view.

Our study integrates the study of political strategy and political governance into the interactive setting of foreign subsidiaries with the local government of China. In so doing, the contribution has been added to both streams of studies. Both streams of studies address how to handle political uncertainty in the institutional environment. The stream of political strategies stresses the incentive of capturing external political resources (e.g. Bonardi et al. 2005; Shaffer and Hillman, 2000), while the stream of political governance stresses the choice of political strategies (e.g. Henisz and Zelner, 2004). The focus of political strategy studies has been extended from domestic firms to foreign subsidiaries (e.g. Blumentritt and Nigh, 2002; Hillman and Wan, 2005), but these studies are mostly US-based in terms of either firms or the context. In addition, the study of political governance is more conceptual. Our study contributes to both by extending to the context of transition economies. In doing so, we integrate resource dependence theory and transaction cost politics with institutional theory and organizational capabilities. Our study shows that the political strategy and political governance converge and firms' behavioural choices are not only triggered by uncertainty mitigation, but also moderated by institutional constraints and firm capabilities.

Furthermore, our study contributes to contextualization of strategy and international business. Studies in international business call for attention to transition economies where the institutional environment differs greatly from the developed economies (e.g. Buckley and Lessard, 2005; Shenkar, 2004; Wright et al. 2005). The context of organizations has significant influences on their behaviours and strategies (e.g. Brasher and Lowery, 2006; Johns, 2006; Rousseau and Fried, 2001). Our study, relying on case studies, points out the specific political hazards and institutional constraints that are embedded in the context of China, and organizational capabilities that are particularly salient in operating in China. The contextualizing of the study emphasizes the significance of informal institutions in shaping incentives, constraints and organizational capabilities as well. It suggests that these informal institutions can and should be integrated into the consideration of theory building.

This cross-discipline study is proved to be insightful to practitioners in the business field as well. Watkins (2003) strongly states that few firms in practice manage their relationship with the government successfully. Our contextualized case study categorizes specific factors of incentives, constrains, and organizational profiles respectively. It further describes their effects and the underlying logics. These findings show how foreign subsidiaries can optimize their relationship with the local government in China. The same logic can be extended to the relationship with the national government, and political strategies of other kinds of firms (e.g. domestic firms) in China.

The limitation of the study is its generalizability. A case study is advantageous in exploring new insights and theory building, but weak in generalizing the findings in a broader context. Therefore, we are cautious to make any statement on generalizability. However, the diversity of our cases provides strong support to our findings. These preliminary findings extend previous studies of political strategy and political governance by applying a cross-discipline approach, and thus formulate some tentative propositions. To further generalize our findings, these propositions need to be verified by either more rigorous case studies in other context of transition economies or by robust econometric analysis.

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Figure 1 Analytic Framework of MNC-Host government relationship in China

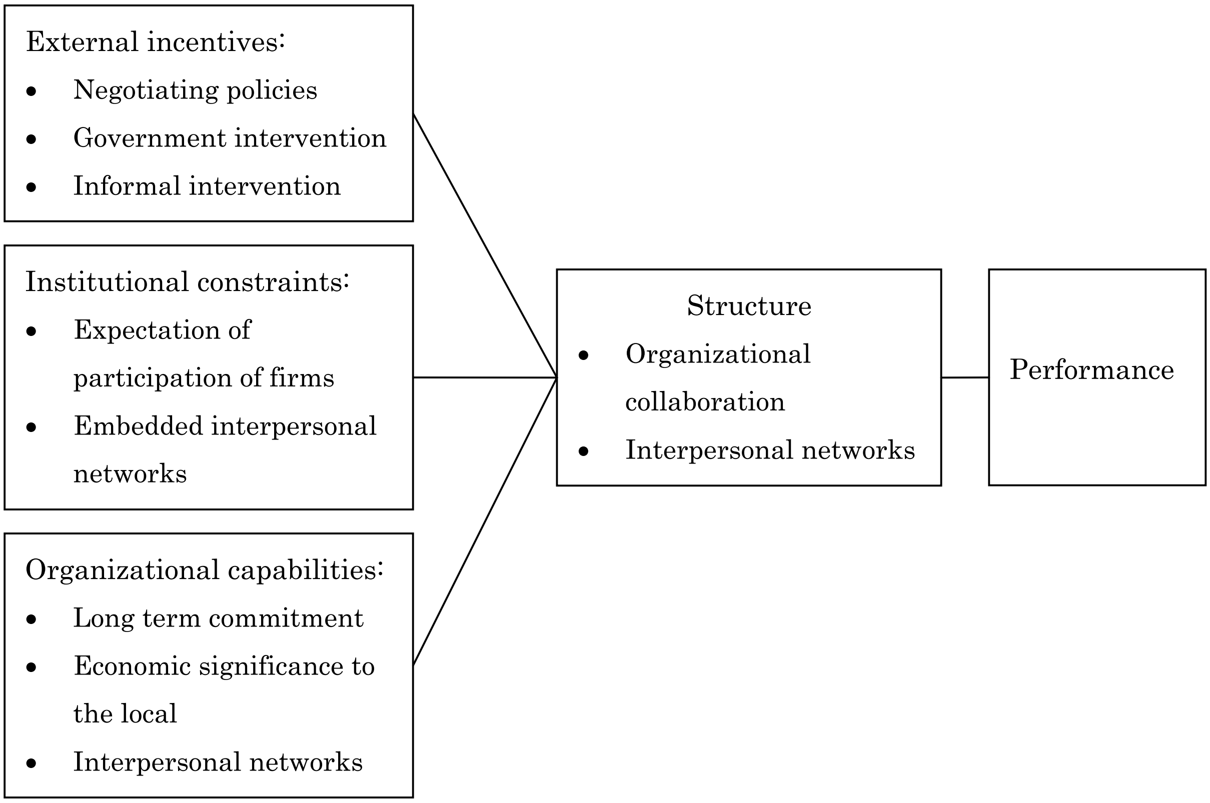

Table 1 Profile of Cases

No.	Industry	Country of origin	Founding year	Size	Ownership
1	Construction material	Germany	1999	Small	Joint venture
2	Textile	Taiwan	1993	Big	Foreign subsidiary
3	Electronics	South Korea	1994	Mid	Joint venture
4	Electronics	Singapore	2004	Big	Foreign subsidiary
5	Electronics	Netherlands	1994	Big	Joint venture
6	Machinery	USA	1997	Mid	Foreign subsidiary
7	Telecommunication	USA	2004	Big	Foreign subsidiary
8	Pharmaceutical	UK	1997	Big	Foreign subsidiary
9	Telecommunication	USA	2003	Big	Joint venture
10	Electronics	Japan	1992	Big	Foreign subsidiary
11	Daily goods	France	1999	Small	Joint venture
12	Telecommunication	France	1994	Big	Joint venture

Note: (1) Size is judged by its employment scale or investment capital: small: less than 100 employees or US $ 1 Million; mid: less than 500 employees or less than US $ 5 million; big, others. (2) Grey blocks are invalid cases.