

**Mike W. Peng**

## **Controlling the Foreign Agent: How Governments Deal with Multinationals in a Transition Economy<sup>1</sup>**

### **Abstract**

- Employing a principal-agent framework, this article examines the interaction between the state and the multinational enterprises (MNEs) that invested in China's transition economy. It accomplishes this by drawing on and extending Harwit's (1995) three joint venture cases of Beijing Jeep, Shanghai Volkswagen, and Guangzhou Peugeot in the automobile industry.

### **Key Results**

- Significant conflict of interest was found between the state and the MNEs. The relationship was also moderated by local governments acting as agents of the state, resulting in an "agents controlling agents" scenario.

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Manuscript received August 1997, revised July 1998, revised January 2000.

*A contract is only a truce, and very precarious, it suspends hostilities only for a time.*  
– Emile Durkheim (1933, p. 365)

Since principals in modern organizations have to delegate certain tasks to agents and agents may have an inherent conflict of interest with principals, how to control agents has become a major issue for organizational practitioners and researchers (Jensen/Meckling 1976). In this article I extend the work on organizational control into an important but overlooked area, namely, how the state controls multinational enterprises (MNEs) as foreign agents. While government-MNE interaction has been studied extensively in the international business literature (Behrman/Grosse 1990, Brewer 1992), very few studies have examined such an interaction in a transition economy such as China.

In light of China's recent rise as a major recipient country of foreign direct investment (second only to the United States in the 1990s) and the Chinese government's manifest interest in maintaining strong control over these activities, it is important to investigate (1) how government agencies at different levels control the MNEs as foreign agents, and (2) how effective these activities are. Answers to these questions will not only be of theoretical significance to the literature on organizational control, but will also help international business practitioners gain more knowledge about the dynamics surrounding MNE activities in transition economies (Peng 2000, Peng/Lu/Shenkar/Wang 2001). This article draws on and extends Harwit's (1995) three case studies of joint ventures in the automobile industry, Beijing Jeep, Shanghai Volkswagen, and Guangzhou Peugeot, to critically examine the interaction between the Chinese state and MNEs. From a principal-agent perspective, I focus on the conflict of interest between the state and the MNEs, as well as the dynamics of this relationship moderated by local governments acting as "agents of the state."

## **The State as an Organization**

### **A Central Assumption**

A central assumption of this article is that the state can be regarded as an "organization" interested in maintaining control over its agents. "The state, as a center for political control, a prop for the property system, and locus of struggle, is a particular kind of organization" (Collins 1988, p. 450). There is, in fact, a popular observation that the Chinese economy, especially during the pre-reform period (1949–1978), can be regarded as "China, Inc." (MacLeod 1988). Collins (1988, p. 487) suggested that the socialist state can be regarded as a "superorganization." In contrast to market economies, planned economies feature the comprehensive

use of economic planning. A national plan is developed by the central government and then is incrementally decomposed into a set of targets and orders for specific local units. Such a description parallels with the workings of the typical, large Western corporation in which a strategic plan coordinates and controls the operations of various subordinate units (Peng 1996). Therefore, at a first glance the assumption to treat the Chinese state as an organization appears to be useful.

At a more theoretical level, the "state-as-a-firm" theory by Auster and Silver (1979) also justifies the assumption of treating the state as an organization. Specifically:

*States are simply firms, although admittedly ones that produce primarily public goods. "Firm" is the economist's word for the micro-decision unit for production. It is the institution by which the various factors of production, labor, capital are combined to produce the levels and qualities of outputs that "society decides" to produce. From the perspective on society that all exchanges are subject to the same underlying laws, states are simply service firms. They make decisions regarding certain services used by society (Auster/Silver 1979, pp. 1-2).*

In sum, both the popular observation of the organization-like feature of the Chinese state and the "state-as-a-firm" theory combine to suggest that it may be plausible to treat the state as an organization.

### **The State and Its Agents**

In reality, the socialist state is far from the ideal type of "one large, coordinated organization, owned and controlled by the entire people who harmoniously plan all economic activities" (Collins 1988, p. 487). The rationality of the state, whose government agencies theoretically function smoothly according to a plan, is actually a *myth* (DiMaggio/Powell 1983). Instead of a well-coordinated plan, extensive intra-elite bargaining has been reported (Lieberthal/Oksenberg 1988). For example, Lampton (1992) used the metaphor of a "bargaining treadmill" to describe the political decision making process. Peng (1996) suggested that the "corrupted M-form" model best captures the essence of bureaucratic bargaining in China. Given the fragmented authority of the Chinese state, a rational plan becomes unattainable because constant changes have to be made in order to accommodate various interest groups.

Like all principals, the state has to rely on agents at various levels to achieve its objectives (Huang 1996). The distribution of power between the state and its agents such as provincial governments and state enterprises in China is heavily skewed toward the former. Since 1949, the state established elaborate bureaucratic controls over the political, economic, and social spheres of its subordinates, creat-

ing virtually a Weberian “iron cage.” The controls are so extensive that, according to Shenkar (1996), Chinese state enterprises may be similar to the “total institutions,” such as prisons, mental hospitals, army barracks, and boarding schools found in the West, where both work and non-work life is constantly under severe surveillance and control. While this metaphor may be extreme, the scale and scope of the bureaucratic control by the state are clearly illustrated.

Interestingly, despite the encroachment by the state, various agents such as local governments and state enterprises carry on a life of their own, managing to take care of their own interests by bargaining hard with the state (Lu 1996). In addition, “each level slightly deflects [state] policy in a direction favorable to its interests; by the time one policy has moved through six, seven, or more layers of the system, the cumulative distortion can be great” (Lampton 1992, p. 57), hence the saying “Whenever there is a policy from the state, there emerges a solution from the grass roots.” As stakeholders, various agent groups have their own cost-benefit analysis (Hill/Jones 1992). Local governments, after tasting some autonomy during the reform era, tend to become unwilling to follow the center’s political directives, thus fueling “localism” at the expense of the state (Chung 1995, Huang 1996). State enterprises often “strategize” by hoarding resources and concealing capacity from their bureaucratic superiors in order to obtain plans that are easy to fulfill (Peng 1997a, 2000, Peng/Heath 1996).

As a result, the state has experienced severe “control loss” problems. Using the language of principal-agent analysis (Eisenhardt 1989a, Jensen/Meckling 1976), the state, as a principal, cannot fully control the behavior of its agents, and it is inherently stuck in bargaining relationships with agents that have diverse objectives and interests.

## **Controlling Foreign Direct Investment (FDI)**

### **Government-MNE Relationship**

Interestingly, the relationship between host governments and multinational enterprises (MNEs) has also been characterized as a bargaining model (Behrman/Grosse 1990, Brewer 1992). Specifically, this model suggests that the outcome of such a relationship, namely, the scale and scope of FDI in a host country, is a function of the relative bargaining strength of the host governments and the MNEs (Murtha/Lenway 1994). MNEs typically want to minimize the intervention from host governments, and governments, especially those in developing countries, usually want to ensure a certain degree of control (Dunning 1993). For the host government, the problem is that it “must coerce or cajole the multinationals into undertaking roles that they would otherwise abdicate” (Evans 1979, p. 44). How-

ever, the government has to "induce, rather than command" (Lindblom 1977, p. 173). Such a problem can be conceptualized as an agency problem for the state, specifically, how to control the agents from abroad (MNEs) so that the behavior of the agents is not entirely at odds with what the principal (the state) desires.

Underlying this model is the view that FDI is not a zero-sum proposition. Despite the myriad potential conflicts, there is a range of conditions within which the interests of a host country and a foreign investor may converge on an outcome that makes each side better off. Since the late 1960s, this model has become "*the currently accepted paradigm*" of government-MNE relations in international business research (Kobrin 1987, p. 610, original emphasis). Empirical studies based on this model have been published for groups of African (Poytner 1982), Latin American (Fagre/Wells 1982), Southeastern Asian (Encarnation/Wells 1985), and East European countries (Brouthers/Bamosy 1997), as well as major developing countries such as Brazil (Evans 1979), Chile (Sampson 1973), India (Grieco 1982), Indonesia (Aswicahyono/Hill 1995), and Mexico (Weiss 1990). However, very few empirical studies on government-MNE relationship have been reported for China.

### FDI in China

In China, the political change toward an "open door" policy since the late 1970s brought a new challenge to the state that it did not have to deal with before, namely, the control of FDI brought by MNEs. It was believed that by absorbing FDI China would gain access to new capital, technology, and management skills, as well as international markets. On the other hand, MNEs, as *de facto* agents, had a different set of objectives and interests when they came to China. They were primarily interested in China's huge market potential. As a result, principal-agent conflicts of interest became inevitable.

When dealing with the MNEs, the state strongly favored joint ventures between MNEs and China's state-owned enterprises (Beamish 1993, Pearson 1991). It was believed that joint ventures best served the Chinese interests of absorbing foreign capital, technology, and management expertise, while affording the government substantial control. Although domestic agents have already caused severe "control loss" problems for the state, a broad range of coercive policy tools are still available for the state to control them. MNEs, on the other hand, are more difficult to control. The distribution of power between the state and MNEs is not as much in favor of the state as is the case between the state and its domestic agents. Compared with the domestic agents, MNEs are much more powerful. They possess a vast array of financial, technological, as well as organizational resources accumulated from their worldwide operations and from their experience in dealing with host governments elsewhere. With alternative investment sites, they also

do not have to come to invest in China (Pearson 1991). Such an international environment places a real limit on the oppressive nature of the Chinese state since it has to modify its behavior in order to accommodate the interests of a group of new agents from abroad (Murtha/Lenway 1994). In short, with ample resources and exit options that are unavailable to domestic agents, MNEs have stronger bargaining power, thus making the task of controlling them a tremendous challenge for the state.

Moreover, in many instances, the central government has to rely on local governments to act as agents of the state to control FDI activities in their jurisdictions. Local governments may not have the identical cost-benefit criteria as Beijing has in their dealings with the MNEs, thus posing further potential agency problems for the state (Chung 1995, Huang 1996). As a result, the interaction between the state and MNEs, moderated by local governments' own agency behavior, provides an interesting setting to examine how government agencies at different levels control the MNEs as foreign agents.

## **Methodology**

### **Choice of Method**

The methodological task was to find a way to critically examine the interaction between the Chinese state and MNEs. Broad-based overviews of FDI in China (Beamish 1993) and large-sample quantitative studies (Luo/Peng 1998, 1999, Tse/Pan/Au 1997), while important, did not focus on the specific task of control. Although emphasizing the Chinese government's dealings with MNEs, Osland and Bjorkman (1998) and Pearson (1991) took a very broad perspective, covering the whole spectrum of the FDI process. As a result, they did not examine any industry- or firm-specific cases, and thereby lost some of the analytical power that might be obtained by focusing on one issue area in one particular industry (Brewer 1992). On the other hand, case studies on joint ventures, such as Mann (1989), Peng (1995), Yan and Gray (1994), and Tan (1997), while rich in detail, mostly focused on the MNEs' perspective and left the issue of establishing control by the state unexplored. In this article, I draw on and extend Harwit's (1995) work to focus on the control of FDI in a particular industry in China from the perspective of the state, thus providing both focus and depth.

Given the paucity of empirical research on the control of FDI in China, an exploratory effort building on three embedded case studies of major automobile joint ventures was undertaken by Harwit (1995). According to Yin (1989, p. 49), an embedded case study contains more than one unit of analysis in the same case, and thereby permits a comparison across units of analysis. Such a method is also

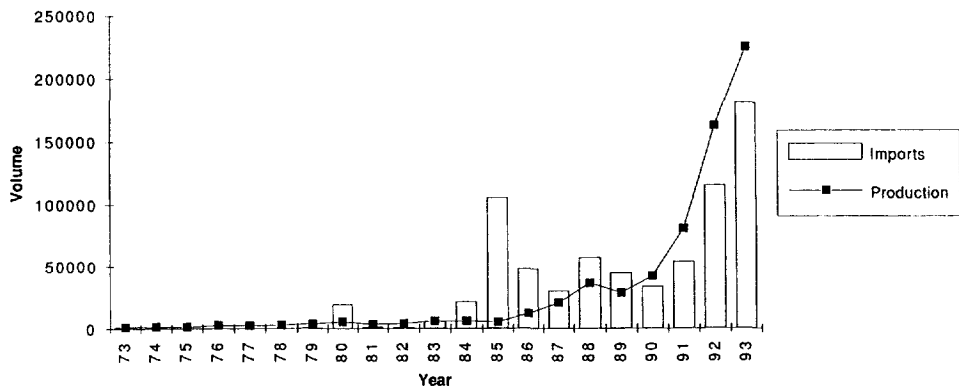
in line with recent empirical work on government-MNE relationships (Aswica-hyono/Hill 1995, Weiss 1990), Chinese bureaucratic politics (Lampton 1992, Lieberthal/Oksenberg 1988), as well as firm behavior in China (Lu 1996, Peng 1995, 1997a, Yan/Gray 1994).

## Industry Background<sup>2</sup>

The Chinese government attached great importance to the automobile industry, and a wide variety of bureaucracies at both the central and local levels interacted with MNEs and the joint ventures they created (Harwit 1995, Xing 1997). By the late 1970s, China's automobile industry remained in need of modern technology, despite nearly three decades of development. Annual passenger car production throughout the 1970s, at around 1,500–2,000, was negligible for a such a large country (Figure 1). Since domestic production could not meet the demand, imports of passenger cars rose to 105,775 in 1985. The bill for the import binge peaked at a staggering \$3 billion<sup>3</sup> in 1985, thus creating heavy pressure to drain the country's limited hard currency resources. It was clear early on that the country needed a strategy to stem the huge outflow of hard currency to pay for the imports. It was with this motivation that joint ventures which would produce cars in China were sought.

In this new policy domain, the Chinese state relied on different bureaucracies at the central and local levels to achieve control. At the central government level, the State Planning Commission was responsible for formulating the national economic plan. For the automobile industry, which was under the jurisdiction of the Ministry of Machine-Building Industry, the Commission was of vital importance because it had virtual control over the numbers and types of vehicles the joint ventures could produce. Since both the Commission and the Ministry had other re-

**Figure 1.** Annual Passenger Car Production and Imports in China, 1973–1993



sponsibilities, they had to delegate the day-to-day control to a quasi-ministry, China National Automotive Industrial Corporation (CNAIC), which had the mandate of formulating and implementing automotive planning on a national basis.

In addition to the central-level agencies, local-level bureaucracies were also involved in the control of foreign investment process. Mayors in the three major cities where automobile joint ventures were established varied in their participation of this sector. Beijing's mayor in the 1980s was not very involved, but the mayors of Shanghai and Guangzhou took an active interest. Each city also delegated one or more vice mayors to supervise the development of the automobile industry. Guangzhou's vice mayor in charge of that sector even became the board chairman of Guangzhou Peugeot from 1985 to 1987. As a result, local control and influence over the creation and operation of the joint ventures was also significant (Harwit 1995, Xing 1997).

#### Theoretical Sampling and Data Collection<sup>4</sup>

Theoretical sampling refers to seeking samples of populations, events, and activities guided by the researcher's emerging theory (Glaser/Strauss 1967). Harwit's emerging theory, informed by the conceptualization that local governments might also create agency problems for the state, suggested that Chinese bureaucracies at various levels might have dealt with MNEs differently, due to their different preferences. Thus, he sought to examine the behavior of the bureaucracies at both the central and local levels, by adopting a multiple case study design in order to achieve theoretical replication suggested by Yin (1989). Moreover, the three case studies formed the entire *population* of Sino-foreign passenger automobile joint ventures established during the 1980s,<sup>5</sup> thus allowing for a *census*, instead of sampling, of the phenomenon of interest. Finally, since the control of FDI is a dynamic two-way process that involves both the government and MNEs, Harwit not only interviewed Chinese officials in the government, but also queried representatives of MNEs and the joint ventures in order to get "the other side of the story."

In the early 1990s, Harwit gathered both archival and interview data. He interviewed multiple informants from both sides for each joint venture in order to minimize the drawbacks of using a single informant. All together, Harwit used 22 interviewees from both sides. The interviewees were usually knowledgeable about the events surrounding the joint ventures. A typical interview would last one to three hours. He prepared a set of questions before entering the field. These questions centered on (1) the relations between MNEs and central/local governments, (2) confirmation of and additions to published statistics, and (3) current and future prospects for the ventures. The format of the interviews was semi-structured, in that all prepared questions were covered, while leaving sufficient time during the interviews to explore other important issues.



**Table 1.** A Summary of Harwit's Three Joint Venture Cases

<b>Joint Venture Cases</b>	<b>Beijing Jeep Corporation, Ltd.</b>	<b>Shanghai Volkswagen Automobile Company</b>	<b>Guangzhou Peugeot Automobile Corporation</b>
<b>Negotiation</b>	1979–1983	1978–1984	1980–1985
<b>Total initial capital</b>	\$51 million	\$40 million	\$52 million
<b>Foreign partners</b>	American Motors Corporation (31%)*	Volkswagen (50%)	Peugeot (22%) National Bank of Paris (4%) International Finance Corp.** (8%)
<b>Chinese partners</b>	Beijing Automobile Works (69%)	Shanghai Automotive Industrial Corp. (25%) Bank of China (15%) China National Automobile Industrial Corp. (10%)	Guangzhou Automotive Manufacturing (42%) China International Trust & Investment Corp. (20%) Industrial & Commercial Bank of China (4%)
<b>Contract length***</b>	20 years	25 years	25 years
<b>Products</b>	Jeep Cherokee four-wheel drive vehicle	Santana four-door sedan	504 light truck 505 station wagon
<b>Production began</b>	1985	1985****	1986

Source: Harwit (1995)

\* Later raised to 42% after Chrysler acquired AMC

\*\* A World Bank organization

\*\*\* At the time of signing the contract

\*\*\*\* Trial production was run in 1983–1984

In this article, when analyzing Harwit's interview data, I used an iterative approach to travel back and forth between data, pertinent literature, and emerging theory. Each joint venture's history was first constructed, thus generating a series of "minicases" (Eisenhardt 1989b). It was important to examine these cases in sufficient detail in order to seek patterns of such interaction. Each case was then reviewed to see if the overall pattern was confirmed, rejected, or ambiguous (see Table 1 for a summary). Aware of the difficulties involved in conducting field work in China (Peng 1997a), I present and interpret Harwit's data modestly, blending in or contrasting findings and arguments with what is known from the literature.

## Case 1: Beijing Jeep

### Case History<sup>6</sup>

Beijing Jeep was the largest and most visible manufacturing joint venture established by an MNE and the Chinese in the early 1980s (Harwit 1995, Mann 1989, Tan 1997). The negotiations American Motors Corporation (AMC) and CNAIC on behalf of the central authorities took four years since 1979. An agreement was signed in 1983 to establish a joint venture named "Beijing Jeep Corporation" by AMC and Beijing Automobile Works, a state-owned enterprise. Out of a total of \$51 million initial capital, AMC held 31 percent, contributing \$8 million in cash and technology judged to be worth another \$8 million. The 69 percent share that Beijing Automobile Works contributed included buildings, equipment, and \$6.6 million in RMB, the non-convertible local currency.

Intense differences of objectives between the two sides were clear from the beginning. The Chinese hoped that the Americans would help design a completely new model. Moreover, they wanted to export most of the venture's output. The Americans, on the other hand, were primarily interested in selling completely knocked down (CKD) kits of their existing Jeep Cherokee model for local assembly. In the end, the Americans signed the joint venture contract pledging to help develop a new model that the Chinese insisted on but gave little detail on the timing and financing of the process.

After the initial "honeymoon" period, both sides quickly found that the new vehicle was not easy to design. Facing potentially hundreds of millions of dollars in further investment to create a new model, the Americans balked. They insisted that the Chinese import the Jeep Cherokee CKDs for domestic assembly, and that, implicitly, let AMC make a profit on kit sales (a goal that, according to some interviewees, might have been AMC's original intent). The Chinese side reluctantly gave up the plan for the new model, on the condition that the kit parts would gradually adopt Chinese-manufactured components, a process called "localization." The first Cherokees assembled from CKDs were produced in September 1985.

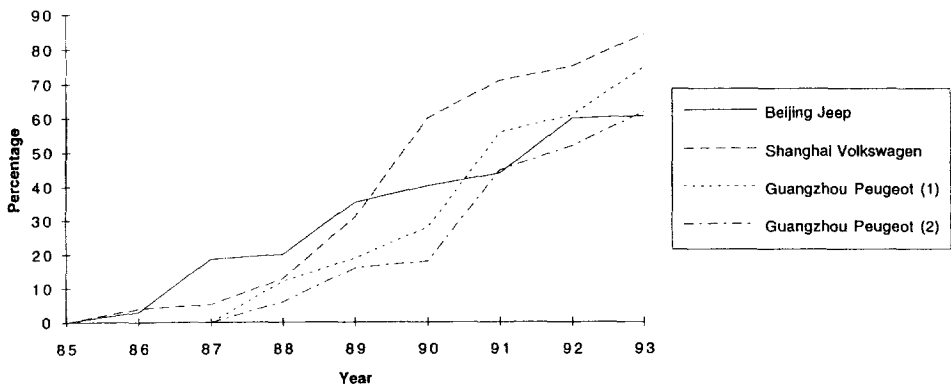
However, since the joint venture made all its domestic sales in the non-convertible RMB, it had no way to pay for continued imports of the kits unless hard currency was provided by the Chinese side. As noted earlier, in 1985-86, China's balance of trade was hurt by a surge of automobile imports (see Figure 1). The state tightened its control over foreign exchange and refused to provide hard currency to pay for the CKDs. AMC, on the other hand, would not accept RMB as payment for the CKDs. As a result, the joint venture's assembly line had to halt production in early 1986.

The Americans notified Chinese bureaucracies at all levels, including, progressively, the Beijing Municipal Government, CNAIC, the State Planning Commission, and, eventually, the State Council. But no solution was forthcoming.

Frustrated, the Americans publicized the crisis by complaining to Western media such as the *Wall Street Journal* and *Business Week*, which published reports on the crisis in April 1986. They also wrote directly to the Chinese Premier, with a concrete threat of shutting down the joint venture. The letter asked: "What will world opinion be of the investment climate in China if this venture fails?" Only through the intervention from the then-Premier, Zhao Ziyang, was the venture saved. The central government agreed, as an exception, to release emergency hard currency and postpone the development of a new model, thus avoiding the great embarrassment of losing Beijing's largest joint venture at that time.

In the aftermath of the crisis, Beijing Jeep resumed production by mid-August of 1986. While AMC, and later Chrysler after it took over AMC in 1987, continued to sell CKDs and made profits on these sales, the Americans also realized that increasing the local content, a goal that the Chinese side pursued, was also in their best interests. In the long run, continued reliance on the goodwill of the government to provide foreign exchange to purchase the CKDs would be untenable, as long as all the sales of the automobiles were made in China and paid by RMB. Increasing local content would reduce the needs for completely imported CKDs. Therefore, AMC and Beijing Jeep moved ahead to increase the local content. The process was difficult, as capable Chinese suppliers were hard to find. The Beijing local government eventually took a strong interest, realizing Beijing Jeep's potential multiplier effect that could stimulate the local economy. With a vice mayor in charge of the localization program, substantial progress, as shown in Figure 2, was made in the late 1980s and early 1990, reaching 60.8 percent local content by 1993.

**Figure 2.** Progress in Localization: The Three Case Studies



## Analysis

From a principal-agent perspective, this case illustrates the difficulty of the state in controlling a foreign agent that has its own agenda and interests. As a “predatory ruler” (Levi 1988), the state wanted to maximize the benefits brought by the MNE, namely, a completely new vehicle model and self-balancing of foreign exchange. However, the state could only maximize such benefits within the constraints of its relative bargaining power (Murtha/Lenway 1994). In this case, its bargaining power was threatened as its available coercive tools were inapplicable toward the MNE which had the exit option. Unlike domestic agents, the Americans resorted to highly unconventional tactics in making their case, such as publicizing the crisis to the media, bringing the matter directly to the higher authorities, and threatening to shut down the joint venture. In contrast, a Chinese enterprise would never do that to confront the superiors. In the end, the state had to gradually give up its primary goals, first the development of the new model, next the focus on export markets, and to concentrate on the third goal, improving the local content.

This case also challenges the rationality of the state in its dealings with the MNE. Despite the long history of central planning, the planning for the joint venture appeared to be of low quality. The government signed a contract with the MNE which specifically called for the development of a new model, and ended up with importing a large number of CKDs with little hope of developing the promised new model and exporting any significant amount. Similarly, the financing of the CKD purchases was not well planned, resulting in a serious crisis over the shortage of hard currency. Facing the crisis, various bureaucracies seemed to break down, unable to reach a solution until the Premier took a “top down” approach to solve it. Given that the Chinese were still high on the learning curve in their dealings with the MNEs, AMC’s “bait and switch” strategy certainly complicated and contributed toward the failure of central planning for the joint venture.

While questioning the rationality of the Chinese state and exposing asymmetrical power relations between the two sides, this case also suggests that, while the goals of the two sides diverged substantially, they also converged on one area, namely, keeping the joint venture afloat. The Chinese government treated this venture as a flagship project, a potential magnet for further FDI. The Americans offered themselves as a “guinea pig” by willing to risk their capital only a few years after China’s “open door” policy began. It was this convergence of interest that later led to relatively uneventful progress toward increased local content. The role of the local government in Beijing was, at best, ambiguous. Unlike local governments in Shanghai and Guangzhou (see below), the local government in Beijing initially seemed to be indifferent, even when the venture halted production.

In sum, this case highlights the difficulties of controlling a foreign agent that has strong bargaining power. The elites within the central bureaucracies evidently

lacked high-quality planning capabilities, at least initially, for the joint venture. The case also offers insights about how to converge on partially shared interests in order to make the joint venture work. These themes recur several times in the next two cases.

## Case 2: Shanghai Volkswagen

### Case History<sup>7</sup>

Although the Shanghai Volkswagen contract was signed in 1984 after the signing of the Beijing Jeep contract, preliminary talks started in 1978 even before the AMC talks began. Shanghai municipal officials took a direct interest in the negotiations. The Chinese pressed the idea of a new model for export, and the Germans resisted. Instead, the Germans suggested importing CKD kits for their Santana model. Before the contract was signed, Volkswagen proposed a trial operation in Shanghai in order to demonstrate their commitment. It shipped CKD kits to the Shanghai Automotive Industrial Corporation (SAIC), its future partner, and local workers assembled them. In 1983, some 430 vehicles were produced, followed by about 450 in 1984. The trial proved largely successful.

While the negotiations continued, AMC's talks were nearing a conclusion, with the Chinese in Beijing having convinced the Americans to develop a new vehicle model. Why wouldn't the Germans do the same? asked the Shanghai negotiators. Anticipating Beijing Jeep's problems, the Germans ruled out such a possibility, and insisted on the CKD imports with increasing local content. The Chinese were apparently impressed by the German frankness and practicality, and were convinced by the argument, since the Germans had included more details of their plans than had the Americans. Consequently, a contract was signed in October 1984.

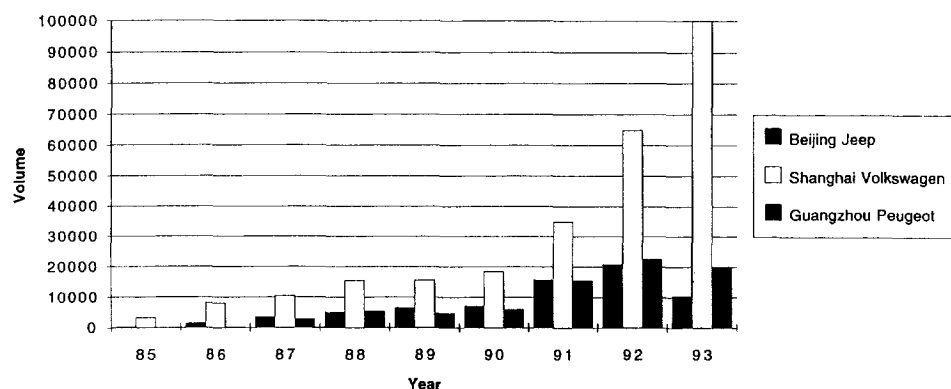
The new company was capitalized at \$40 million. Several details of the contract revealed Volkswagen's careful foresight. First, the new joint venture was owned 50 percent by Volkswagen, 25 percent by SAIC, 15 percent by the Bank of China, and 10 percent by CNAIC. While Volkswagen was the largest shareholder, the diversity of partners provided boundary spanning for the venture's operations: The Bank of China could provide or guarantee needed loans, SAIC would have an interest in solving local problems, and CNAIC could be a link to the central planners. Second, the contract allowed Volkswagen to convert its RMB profits for hard currency until 89,000 cars were produced. Volkswagen thus would avoid the kind of foreign exchange problems AMC faced. Finally, the contract specified that while Volkswagen would try to increase the local content, the responsibilities of developing qualified local suppliers rested squarely on the side of the Chinese.

Still, Shanghai Volkswagen was born on a troubled note in 1985 (Davies 1996). Initially, the city was late, for example, in raising funds for basic infrastructure development and financing key localization projects. These problems were eventually solved, under the leadership of a vice mayor who actively helped the joint venture. More serious problems arose with the central government in 1988. The head of CNAIC began to complain about the joint venture's slow pace of localization, and called for a goal of quickly reaching 80 percent local content, as opposed to 12 percent as of 1988. Such a demand was naive, considering the difficulties of localizing auto components in other countries. Honda, for example, began assembling cars in the United States in 1982, starting with 25 percent American components. It took Honda 10 years to approach its goal of using 75 percent local components (Womack/Jones/Roos 1990, pp. 216–217). To expect the Chinese supplier industry to match or exceed this pace seemed overly ambitious.

Indeed, finding qualified Chinese suppliers was difficult. After decades of isolation, many suppliers were unfamiliar with Volkswagen's high standards. Further, they balked at the large investments needed to reach German standards when the joint venture initially needed merely a few thousand items – only 8,031 Volkswagen Santanas were produced in 1986. But still, CNAIC sought to limit the production of Shanghai Volkswagen by curtailing raw material supplies until the venture reached higher local content requirements.

Volkswagen's precise contract provided some respite for the Germans, as it indicated that the Chinese were responsible for developing local suppliers that would meet Volkswagen's standard. Unlike the Americans, however, the Germans neither complained to the press, nor sought to directly confront the central government. Instead, they chose quiet persuasion and reasoned arguments, and allowed the Chinese to find a solution to the problem. In the end, criticisms from CNAIC abated because of Volkswagen's efforts and also because of the Shanghai local government's, especially the mayor's, lobbying. In fact, the rate of localization at Shanghai Volkswagen was comparable to those of other joint ventures (see Figure 2). It more than doubled its local content during 1988–1989. By the end of 1989, the Santana model contained more than 30 percent local components, while the AMC Cherokee had about 35 percent local content, though Beijing Jeep had begun operations one year earlier. After only eight years of operations, Shanghai Volkswagen eventually reached 85 percent local content level by 1993, thus attaining the highest localization levels among the three ventures.

Volkswagen was fortunate in that with a sympathetic mayor,<sup>8</sup> the Shanghai local government often sided with its position. The reason that the local government in Shanghai showed a strong interest in the joint venture was the enterprise's growing importance. Its production crossed the 100,000 mark by 1993. In the mid-1990s, Shanghai Volkswagen was the largest Sino-foreign joint venture in China, and was listed as a "pillar firm" in Shanghai's development plan (Shanghai Economic Commission 1995). At the venture's full capacity of 300,000 vehicles in 1997, it con-

**Figure 3.** Automobile Joint Venture Production in China: The Three Case Studies

tributed up to 17 percent of municipal output, and captured 52 percent of the sedan market in China (Xing 1997). In comparison, the production growth of Beijing Jeep and Guangzhou Peugeot was not that impressive (see Figure 3).

### Analysis

From a principal-agent perspective, this case again sheds light on the asymmetry of power and interests between the two parties. As with the Beijing Jeep case, the government demanded a new model. However, due to the bargaining power of the foreign agent, this idea was rejected. Once the joint venture was started, there was no illusion that a completely new model would be developed. The Germans neither took an evasive strategy as AMC did, nor did they try to impose their will upon the Chinese. The Germans appeared to be doing what “good” agents would do, by demonstrating the alignment of their interests and the principal’s through the trial assembly operations in 1983–1984. As a result, a basic level of trust had been established before the venture was formed. Later on, in the drive toward higher localization levels, again the Germans refrained from finger-pointing when facing criticism from the central government. Instead, they quietly worked with the local government, thus reaching the mutually shared goals of increasing local content. One interviewee suggested that West German experiences with Eastern Europe might have contributed to a better understanding of the problems in China.

This case is different from the previous case in that two levels of bureaucracies were involved. In Beijing the joint venture was tightly overseen by the central government through CNAIC. In Shanghai, although CNAIC maintained nominal control, it was the local government that was in charge. Local officials, therefore, acted as agents for the state to exercise control over another agent from

abroad, presenting an “agents controlling agents” situation. Under such a scenario, the state, as the predatory revenue-maximizer (Levi 1988), wanted to extract the most out of any deal. On the other hand, local agents, being less predatory, did not want to bargain too hard with the foreign agent in fear of the exit of the MNE. As long as their local interests, such as generating employment, upgrading technology, and developing the supplier industry, were covered, they were willing to settle for less than what Beijing wanted.

In retrospect, Shanghai officials’ “settling for less” strategy seemed to be more rational, realistic, and flexible than their counterparts’ approach in Beijing. While the Beijing bureaucrats concluded a contract which looked great on paper, they failed to anticipate problems that immediately arose at Beijing Jeep. In contrast to the “quick and dirty” type contract that AMC signed in Beijing, the decision quality for the Shanghai venture was evidently better, the contract signed more detailed, and the planning more thorough. Moreover, the organizational capabilities of the Shanghai bureaucracies seemed to be better than those of the central agencies in Beijing. As a result, problems were solved more speedily and, unlike the Beijing Jeep case, higher authorities never had to intervene.

In sum, the Shanghai Volkswagen case provides an interesting case of a peculiar “agents controlling agents” situation. While the asymmetrical power relations and partially shared interests in the government-MNE interaction still persist, the local government’s different cost-benefit analysis in its dealings with the joint venture is notable.

### **Case 3: Guangzhou Peugeot**

#### **Case History<sup>9</sup>**

France’s Peugeot SA originally looked to more industrialized northeast China for a joint venture partner. However, Guangzhou officials were proactive in contacting the French, and formal negotiations began in 1980. All the Chinese negotiators were local officials from Guangzhou, and central authorities in Beijing such as CNAIC played little role in the talks. During the course of the negotiations, Beijing Jeep was established and announced its intention to develop a new model. However, according to Guangzhou officials, that event had little impact on their negotiations with the French. Both sides agreed that it would be too expensive, and neither wanted to embark on such a project. They agreed on importing CKD kits for assembly of the Model 504 pickup truck and Model 505 station wagon, with the understanding for increased local content as the venture progressed.

The joint venture contract was signed in March 1985, calling for \$52 million in initial capital. Peugeot took only a 22 percent share. The other foreign partners



included the National Bank of Paris (4 percent) and the World Bank's International Finance Corporation (8 percent). The main Chinese partner, Guangzhou Auto Manufacturing, held 42 percent. The remaining equity was held by the China International Trust and Investment Company (20 percent) and the Industrial and Commercial Bank of China (4 percent). The Chinese side, therefore, owned 66 percent of the venture.

Thousands of miles away from Beijing, Guangzhou traditionally is a region where "heaven is high, and the emperor is far away" (Vogel 1989). Its automobile development also had more latitude from Beijing than did other cities. In 1990, for example, CNAIC had no representative in the distant province. Having greater autonomy, the Guangzhou local government took a special interest in the joint venture. A vice mayor became Guangzhou Peugeot's board chairman from 1985 to 1987. He lobbied in Beijing to allow the venture to import more CKD kits, and negotiated in Paris to obtain new plant equipment for the venture. In Guangzhou, he also prodded the provincial bureaucracies to speed up decisions.

Unlike Beijing Jeep, Guangzhou Peugeot initially suffered no apparent shortage of foreign exchange, since it could obtain hard currency loans from its partners, the National Bank of Paris and International Finance Corporation. However, the growing strength of the French franc led to disagreement over the price for CKD kits in 1986. The contract called for Guangzhou Peugeot to purchase CKD kits at a fixed franc price. It stipulated the 1985 CKD price to be 47,000 francs, and the 1986 price to rise to 53,580 francs. From mid-1985 to early 1987, the franc appreciated 110 percent against the RMB, thus substantially raising the RMB price of the vehicles assembled. With the franc's appreciation, the price effectively rose from \$5,060 in 1985 to \$8,500 by the end of 1986. In July 1986, the Chinese demanded that Peugeot lower its CKD price, but the French balked. The disagreement resulted in nearly six months of negotiations. Eventually, the two sides agreed on a price of 48,000 francs, and orders resumed in early 1987.

The new company had problems typical for other automobile joint ventures. The facilities were outdated and workers poorly trained. The French had underestimated the number of expatriate staff needed. The main problem, however, was procurement of local components of sufficient quality. Initially, it could not find suppliers for glass, paint, tires, and other relatively simple items that reached its standards.

Guangzhou Peugeot soon discovered that it was necessary to rely on the local government for its parts development. The local government greatly fostered the localization process, which began in earnest in 1988. From 1988 to 1990, the city invested some RMB 200 million to develop the supplier industry, allowing Guangzhou Peugeot to source car seats, headlights, dashboards, carpets, and other items locally. By 1990, about 19 percent of the pickup truck (Model 504) and 16 percent of the station wagon (Model 505) came from domestic sources (see Figure 2). The municipal government had much to gain from the joint venture's success, because,

by 1991, the venture itself made 30 percent of the Chinese-made parts in-house, and other Guangzhou area suppliers contributed 20 percent. By 1993, the venture's two models reached 75 and 62 percent localization levels. The output volume, however, at about 20,000 in 1993, remained modest when compared with Shanghai Volkswagen (see Figure 3).

## Analysis

Similar to the Shanghai Volkswagen case, this case further illustrates the strong role played by local agents in an "agents controlling agents" situation. While the central government was interested in developing a new model, Guangzhou officials did not even bother to negotiate that with the French. Thus, from the beginning, Guangzhou officials demonstrated more autonomy, when compared with their counterparts in Shanghai and Beijing. In the venture's later development, there was little influence or intervention from the central government or the CNAIC; instead, the Guangzhou local government took a strong interest in the development of the joint venture. This represented a rather extreme form of local political support, and may be regarded as a variant of what Nee (1992) called "collective-hybrid." While Nee was referring to the strategic alliance between indigenous collective enterprises and local politicians in rural China, in this case, the MNE aligned its interests with those of the local government, resulting in a strong coalition.

Building on two previous cases, this case helps shed light on the government-MNE interaction in a number of ways. First, in terms of the asymmetrical power relations between the central government and the MNE, the local government can help tilt the balance to be relatively in favor of the MNE, which correspondingly experienced little central criticism or intervention. In other words, vital political resources (Boddewyn/Brewer 1994) provided by the local government helped alleviate the intrusion from the state. Second, the central government seemed to have taken a historically derived "indifferent" approach in governing Guangdong province. As a result, much of the control task was delegated to Guangzhou officials, who were less predatory and more accommodating toward the joint venture. Finally, better working relationships between Guangzhou officials and the joint venture allowed for more reasoned and dialogue-based solutions when conflict, such as the disagreement on CKD prices in franc, occurred.

## Discussion

Across these three cases, a fundamental pattern is the conflict of interests between the state and the MNEs. In this process, while the state attempted to control the

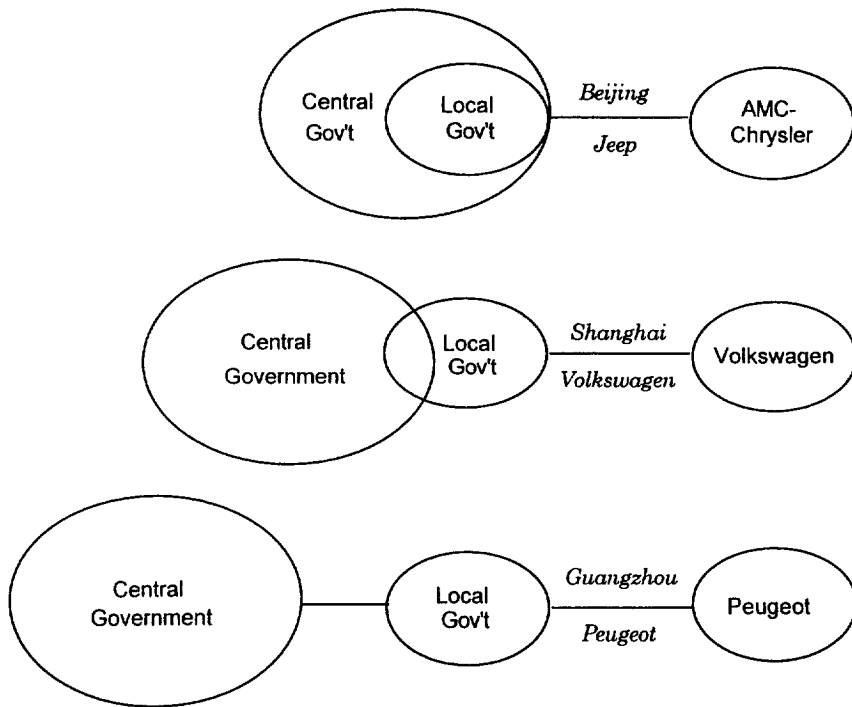
foreign agents, the MNEs also exercised substantial bargaining power. Despite its lack of experience in this new policy domain, the central government was able to maintain ultimate control over the foreign investment policy. The government was also effective at establishing a number of specific controls at the national level, such as maintaining strict control on foreign exchange. On the other hand, severe problems in the implementation of these controls occurred. In each of the joint ventures studied, the MNE held no more than 50 percent shares, and the Chinese side, in theory, held majority control. Yet, it was clear that foreign managers were in charge. The MNEs largely fulfilled their objectives of capturing the China market, whether by AMC's "bait and switch" strategy or by Volkswagen and Peugeot's more frank approach.

Furthermore, when relying on local governments as local agents to control the foreign agents, the central government experienced "control loss" problems. Especially in the case of Shanghai Volkswagen and Guangzhou Peugeot, local governments became more sympathetic toward the joint ventures, which generated economic benefits to their jurisdictions. As a result, from the central government's perspective, local governments apparently "settled for less." During later stages of the joint venture development, local governments, except in Beijing, tended to actively lobby for the joint ventures and bargained hard with the central government. The case of the local government in Beijing was more peculiar. Being the capital city, Beijing traditionally was under closer central scrutiny, and its local government tended to be overshadowed by central intervention. In sum, different patterns of the government-MNE relationships have been clearly illustrated by these three cases (Figure 4).

Overall, these cases portray the dynamic interaction between the central government and MNEs, moderated by local governments which often align their interests with those of the joint ventures. These cases reveal the weakening power of the central government, which had to grant concessions to the MNEs on one hand and to share its power with increasingly assertive local governments on the other hand. The bargaining model of Chinese bureaucratic politics suggests a scenario in which different domestic players bargain over what is scarce (Lampton 1992), and the bargaining model of government-MNE relationships features extensive "give-and-take" by both sides (Behrman/Grosse 1990, Kobrin 1987). My extension of Harwit's (1995) three cases integrates these two bargaining models by *simultaneously* focusing on a different and powerful group of stakeholders as *de facto* agents from abroad and highlighting the moderating role of a group of domestic agents that supported the foreign agents.

My analysis of Harwit's findings also reveals partially shared interests which may lead to dialogue-based solutions of the conflicts between principals and agents (Alvesson/Willmott 1992). Traditionally, the Chinese state did not engage in serious dialogue with agent or stakeholder groups; rather, the state behaved in a very oppressive and predatory way, often unilaterally unleashing its forces upon stake-

Figure 4. Different Government-MNE Relationships in the Three Cases



holder groups without much consultation or dialogue (*e.g.*, the Cultural Revolution and Tiananmen). These joint venture cases are interesting because they show that the state is more or less forced to engage in dialogues with the MNEs, upon which the traditional coercive tools could not be applied very effectively. As a result, the partially shared interests of both parties are evident, since neither side would like to see the joint ventures they created fail. Therefore, the context for dialogue-based solutions of the conflicts has been created.

International joint ventures can be inherently unstable (Inkpen/Beamish 1997). MNEs, having acquired sufficient local knowledge, may demand renegotiations with local partners so that these ventures can be restructured in MNEs' favor (Peng 1997b).<sup>10</sup> As a result, local partners may be confronted with these demands. Therefore, as time goes the task to control the MNEs will not be easier; instead, it will become more challenging. While the MNEs learn how to deal with the state as well as the local environment, the state also needs to keep up its learning on how to deal with MNEs' evolving demands.

In sum, my extension of Harwit's three case studies illustrates the diversity of the interaction between governments and MNEs. The stereotype of the state as

a monolithic entity dealing with the MNEs with a consistent set of policies is replaced by the organizational realities within the Chinese hierarchy which consists of multiple layers of governments, each with different cost-benefit analyses when dealing with the MNEs as foreign agents.

### Practical Implications

My analysis of Harwit's three case studies suggests a number of important practical implications. For MNE managers interested in entering China and other transition economies, building coalitions with local government agencies seems to be a good strategy that may pay off in the long run. Although central authorities in China usually have the power to veto investment projects, having a local partner that can clearly gain from these projects and, hence, is committed to these undertakings appears to be enormously helpful (see also Peng 1996, pp. 53–54). Both Shanghai Volkswagen and Guangzhou Peugeot benefited from such a close relationship with the local government in their struggles to get established. In contrast, Beijing Jeep, at least initially, suffered from a lack of local support, and had to resort to highly unconventional and risky tactics such as publicizing the problem to the media and threatening the government to solve its problems.

For policy makers and practitioners in China and elsewhere who are interested in maintaining the control of MNE activities, the analysis highlights the importance of *policy credibility*. When dealing with MNEs which have strong bargaining power, a set of consistent and realistic policies is necessary. The earlier Chinese policy of demanding a new car model and a substantial number of exports appears to be unrealistic, thereby undermining the credibility of the policy. More recently, the Chinese seem to have adopted a more realistic and consistent policy by insisting on the level of local content, and the three joint ventures have made significant progress toward that goal. Government officials are now becoming more professional and predictable than in the past. Some of them understand foreigners and may have studied abroad (Osland/Bjorkman 1998, p. 98). In the long run, only through consistent policy implementation by professional bureaucrats can the state build up its capabilities in dealing with the MNEs as foreign agents.

Since the early 1990s when Harwit conducted these three case studies, a new wave of MNEs have entered China, including automobile firms such as General Motors, Honda, and Mercedes-Benz (*Business Week* 1995, Peng 2000, Xing 1997). As a result, it is important to learn the lessons of these early investors in the Chinese automobile industry (Luo/Peng 1998, 1999).

## **Limitations and Research Implications**

As an exploratory attempt, this article is limited, having examined only three cases in one industry in one country at a particular time. As in any qualitative study, the results, while rich in individual cases, are not statistically significant. Moreover, the politically sensitive nature of Harwit's inquiry might have deterred some informants from sharing complete information with him. And much of the analysis was based on retrospective data, which might have introduced an additional source of bias as a result of faulty memory or retrospective sense making.

Given these limitations, at least two fruitful future directions can be taken. A first direction will be to integrate the principal-agent framework into research on government-MNE relations in more detail and with more rigor. Currently, the mainstream literature typically takes the perspective of the MNEs which enter different countries according to their global strategic interests, and the role of host governments has been downplayed as the receiving end of FDI (Dunning 1993). A principal-agent perspective can challenge such an MNE-centered notion and treat the state as the focal principal that actively attempts to establish controls over FDI.

Second, in terms of empirical context, China appears to be a site of growing interest among international business scholars and practitioners. Future studies can examine such an interaction in other industries, under different periods of time, and in different locations so as to provide a richer understanding of these dynamics. For example, compared with its grip on the automobile industry, the state may be less interested in controlling some "deregulated" industries such as consumer products. Moreover, such research can be extended to other transition economies such as the former Soviet republics and Eastern Europe, where the traditionally oppressive state also had to rapidly learn the new game of bargaining with the MNEs (Brouthers/Bamossy 1997, Peng 2000).

## **Conclusion**

This article began by quoting Durkheim's (1933: 365) classic insights about the nature of the instability of contracts. These words capture a great deal of the essence of the interaction between the state and the MNEs. While the state attempted to control its new agents from abroad, MNEs asserted strong bargaining power. Due to partially shared interests, contracts were signed, joint ventures established, and local production begun. However, this was only the beginning of the "truce" in a Durkheimian sense. Conflicts broke out periodically after the truce was established, and dialogue-based solutions had to be found. In conclusion, the ongo-

ing principal-agent conflict, the principals' attempt to control the foreign agents, and the agents' maneuvers to lessen the control appear to be fertile grounds to deepen our understanding of the dynamic interaction between host governments and MNEs.

## Notes

- 1 This article represents an extension of my collaboration with Eric Harwit, and I thank him for kindly providing his interview data. Preparation of this article was supported, in part, by Centers for International Business Education and Research at the University of Hawaii and The Ohio State University and a Competitive Earmarked Research Grant from the Hong Kong Research Council (project code HKUST6174/98H-CUHK/EI16). I also thank D. Bhawuk, H. Davies, B. Doktor, L. Kelley, Y. Lu, Y. Luo, and O. Shenkar for their helpful comments. An earlier version of this article was presented at the Academy of International Business conference in Banff, Canada, September 1996.
- 2 The following empirical information is condensed from Harwit (1995, ch. 2).
- 3 All monetary figures in this article are in US dollars.
- 4 The case interview data were collected from fieldwork conducted by Harwit (see Harwit 1995 for details).
- 5 Only in the 1990s did new passenger automobile joint ventures start to emerge in China (*Business Week* 1995, Xing 1997).
- 6 The following empirical information is condensed from Harwit (1995, ch. 4, pp. 67–91).
- 7 The following empirical information, unless otherwise noted by the additional post-1995 references, is condensed from Harwit (1995, ch. 5, pp. 92–114).
- 8 Shanghai's mayor in the late 1980s was Zhu Rongji, who rose to become China's premier in 1997 and was widely regarded as a charismatic, reform-oriented leader.
- 9 The following empirical information is condensed from Harwit (1995, ch. 6, pp. 115–32).
- 10 An increasingly large number of MNEs now choose to enter China using wholly owned subsidiaries, attempting to minimize the influence from the government (Vanhonacker 1997).

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