

Performance of domestic and foreign-invested enterprises in China

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Abstract

Despite increasing attention paid to China's enterprise reform since the late 1970s, relatively little is known about the performance of reformed state-owned enterprises (SOEs) and newly formed private firms vis-à-vis foreign firms in China. In this study, we examine the performance of domestic Chinese firms in various ownership categories versus foreign-invested enterprises (FIEs) based on two nation-wide surveys conducted by the National Bureau of Statistics in 1998 and 2002. We found that both domestic non-state-owned firms and foreign-invested enterprises performed better than state-owned enterprises. Meanwhile, three categories of Chinese firms—privately owned, collectively owned, and shareholding—had higher performance levels than the foreign-invested enterprises.

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Reform in China began in the late 1970s. Since then, China has embarked on a path of rapid economic growth. China's GDP in 2004 reached US\$ 1.64 trillion in absolute dollar terms, making it the sixth largest economy behind the United States, Japan, Germany, Britain and France. The breathtaking growth is believed to have come from two main sources: the reformed state-owned enterprises (SOEs), now in the non-state sector, and the foreign-invested enterprises (FIEs).

Other than anecdotal accounts, however, few studies have empirically examined the relative performance of various types of firms in China on a scale large enough to present a comprehensive picture.

There are signs pointing to the increasing competitiveness of Chinese firms (Zeng & Williamson, 2003). By 2005, 18 of them appeared on the list of *Fortune's* largest global 500 firms. Sinopec, a publicly traded Chinese company with majority state ownership, was ranked the 31st largest firm in the world, with revenues of US\$ 75.1 billion and profits of US\$ 1.3 billion. Haier, a former appliance SOE and now a shareholding company with majority state ownership, achieved an annual sales of US\$ 12.2 billion in 2004, catching up to Whirlpool's US\$ 13.2 billion. Haier had not only secured the domestic Chinese market for major household appliances, but also extended the competition to the US market by opening

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up a manufacturing facility in South Carolina with a capacity of half a million refrigerators in 2002. At the same time, Lenovo, a shareholding company headquartered in Beijing, outperformed Dell, Compaq, and IBM to become the largest computer manufacturer in Asia. Its recent acquisition of IBM's personal-computer business has made it the third-largest PC maker in the world (Biediger et al., 2005). In the mobile phone market, domestic firms captured a 50% market share in 2003 at the expense of Motorola, Nokia, and Ericsson.

On the other hand, there are signs pointing to performance discrepancy among Chinese firms. As the market-oriented reform continues, China moves towards a mixed economy. The SOEs, non-SOEs, and FIEs coexist, although the state sector represents a decreasing share in terms of total output. Whereas, SOEs accounted for 77.7% of China's industrial output in 1978, they accounted for only about 28.5% by 1998. Through the reform, the private sector flourished and gained momentum, but the state sector has not effectively addressed its old problems (Lin, Cai, & Li, 1998). It is important to know how the majority of firms in the non-state sector, as opposed to such stars as Haier and Lenovo, compare with SOEs and FIEs.

There is evidence of increasing commitment of multinational firms in China (Li, Qian, Lam, & Wang, 2000). By January 2005, a total of 512,504 foreign-invested enterprises had been approved to set up their operations in China, with a cumulative actual investment of US\$ 566.2 billion. After China's admission to the WTO in December 2001, inflows of foreign investments in China increased rapidly. A total of 43,664 FIEs were approved in 2004, an increase of 6.3% from 2003. The total realized foreign investment was US\$ 60.6 billion, an increase of 13.3% from 2003. While the overall statistics on capital inflows are impressive, there is a lack of comprehensive understanding of the performance of multinational firms in China. The profitability of multinational firms with certain country origins is reportedly on the decline (Pan & Chi, 1999). Further, it appears that multinational firms are abandoning their long-standing strategy of entering China through equity joint ventures (EJVs) (Vanhonacker, 1997). Thus, it is important to evaluate the performance of FIEs as a whole in China, as well as to assess the relative advantages of EJVs and wholly owned subsidiaries (WOSs).

The goal of this study is to examine and compare the performance of Chinese and foreign-invested enterprises in different ownership categories. We are

particularly interested in knowing whether, after years of ownership reform, the former SOEs and new firms in the non-state sector have gained competitiveness vis-à-vis FIEs, and will formulate basic hypotheses addressing this research question. Our statistical tests rely on data obtained from two official large-scale surveys of firms conducted in China in 1998 and 2002. Because these surveys included tens of thousands of domestic and foreign firms, we are able to draw a general picture of the relative performance of these firms with a moderate degree of confidence. We believe that results of this study will be useful to a number of interested parties, including domestic Chinese firms, multinational firms inside or considering entry into China, as well as international investors looking for opportunities in the emerging markets. Our major finding—that some categories of Chinese firms have outperformed the foreign-invested enterprises—is counterintuitive, and should prompt multinational firms to rethink their own competitiveness in anticipation of more fierce competition ahead within China.

1. Ownership reform and domestic Chinese enterprises

The transition from a centrally planned Chinese economy towards a market-oriented one during the past quarter century has been a gigantic economic, political, and social experiment. The reform of state-owned enterprises is at the center of this transition. The first wave of reform, during 1978–1986, was for the state to delegate power to SOEs and permit them to retain part of their profits. Due to increased autonomy and external competitive pressures, most SOEs improved their efficiency; however, deeply rooted problems remained. Then, between 1987 and 1996, the attention was shifted to transforming the operating mechanisms of those enterprises. Some SOEs began to adopt Western-style corporate structure and management systems. From 1997, the issue of ownership reform was brought into limelight. Privatization of SOEs and other means of reform were formally permitted and implemented.

Ownership reform quickened in the late 1990s because the Chinese government found it financially difficult to keep SOEs afloat. In 1998, for instance, the state sector required a government subsidy of 150 billion RMB, or US\$ 18.3 billion (O'neill, 1999). More and more people started to believe that state ownership was the root cause of all the ills of SOEs, and that a well-thought-out ownership structure and management system could save these firms. From a pragmatic

perspective, the central government was forced to allow the SOEs to raise the needed capital from non-state sources, thus opening the door to privatization. By 2002, the central government had adopted the policy of “grasping the large and releasing the small.” Under this policy, the government retained direct control over some of the largest SOEs. It infused additional capital in a hope to make these consolidated industrial enterprises more competitive. Meanwhile, the state relinquished the small- and medium-sized SOEs to the non-state sector through equity sales, auctions, management buyouts, employee shareholder options, and other means.

SOEs have been transformed into three major types of new ownership. The first category is shareholding enterprises. Ownership of these firms is open to all parties, including the state, employees, and private investors. This is the basic form of modern corporations in the West. To ensure the plurality of shareholders, the Chinese government requires a shareholding company to have a minimum of five stockholders—which may or may not include the state—with no maximum limit. The ultimate goal is to turn the SOEs into companies with modern ownership and management systems. When these SOEs become profitable and attractive to private investors both in China and abroad, they will go for public listing in the stock markets. Many of these enterprises have already been listed on the stock exchanges of Shanghai, Shenzhen, Hong Kong, and even New York.

The second category is limited liability firms. Ownership of these firms still lies in the hands of the state, but the state allows them to have a higher level of autonomy. The state is no longer their unlimited creditor. If the firm suffers from unrecoverable losses, the state may let it go bankrupt. This type of reform forces the SOEs to be separated from the state and become independent business entities. They were not turned into shareholding firms, either because there has not been enough capital from private sources, or because the state wants to keep these enterprises in particular industry segments and does not intend to privatize them entirely. Even though the enterprise is still state-owned, the state refrains from direct control of managerial and operational issues. Thus, we treat these firms as non-SOEs.

The last category is privatized SOEs. The ownership of these firms is now privately controlled. In other words, the state has sold these former SOEs to private investors—which may or may not include managers and employees of the firm—at a price. Typically, they have been transformed from smaller SOEs. Whether this type of reform—especially when achieved through management buyouts (MBOs)—should be carried out on a

larger scale and applied to larger SOEs is under hot debate in Chinese society.¹

2. Performance of domestic and foreign firms in China

Reform and open-door policy are two backbones of Chinese economic growth in the past quarter of a century. Whereas reform, especially ownership reform since the late 1990s, has caused some fundamental organizational changes to the domestic Chinese firms. The astounding increase in the inflow of foreign direct investments (FDI) has externally facilitated these changes, as well as reshaped the competitive landscape of the China market as a whole. By 2003, the amount of FDI intake was well above US\$ 50 billion.

While researchers have examined performance of foreign-invested firms in China (e.g., Pan, Li, & Tse, 1999; Luo & Peng, 1999), they have seldom done so in comparison with domestic Chinese firms. The lack of large-scale empirical investigation into the relative performance of domestic and foreign-invested firms in China caused controversies about the effect of FDI in China on the competitiveness of Chinese firms. Some scholars started to express concerns over the negative impact of FDI on Chinese firms and industries in recent years. Huang (2003), for instance, held that the flourish of FDI has been achieved at the sacrifice of China's private sector. This view is being shared by an increasing number of scholars and practitioners.²

The conventional belief that domestic Chinese firms are at a significant competitive disadvantage vis-à-vis multinational firms is widely held. This view has intuitive appeal, and is supported by numerous cases in the early days of economic reform and open-door policy. Thus, even though it is widely known that multinational firms face a “liability of foreignness”—

¹ In the summer of 2004, Professor Larry H. P. Lang of the Chinese University of Hong Kong sparked a major controversy in China by charging China's emerging class of entrepreneurs and professional managers with stealing state assets in the process of SOE reform and privatization. He argued that ownership reform has not strengthened the former SOEs, but instead is detrimental to public interests. In response, China's elite entrepreneurs, allied with liberal economists, fiercely defended the reform, as well as their own behavior. For many months the financial media were dominated by this national debate. Our study provides a partial answer to the controversy.

² For instance, a recent report on the current state of the Chinese automobile industry held that partnering with foreign manufacturers has made Chinese automakers highly dependent on foreign technology, because multinational firms would insist that the Chinese partner give up its R&D activities as a prerequisite for forming a joint venture.

in other words, they incur higher costs than local firms (Hymer, 1976)—in a foreign country, people had no doubt that the performance levels of domestic and foreign firms in China were not comparable to each other. Twenty years later, however, the answer is no longer straightforward. On the one hand, many Chinese firms have made progress through the reform by directly competing with the multinationals. On the other hand, multinational firms should also have made progress by accumulating local knowledge and host-country experience (Luo & Peng, 1999; Steensma & Lyles, 2000).

In the following sections, we analyze the relative advantages of three pairs of organizational forms in China: state-owned versus non-state-owned enterprises; foreign-invested versus domestic firms; and joint ventures versus wholly foreign-owned subsidiaries. We draw insights from three major perspectives in economics, strategy, and organization theories to formulate our hypotheses: the transaction cost theory, the resource-based view, and the institutional perspective. Hoskisson, Eden, Lau, and Wright (2000) identified these three as the leading theoretical perspectives in research on emerging economies. Their view has been supported by other researchers (Meyer & Peng, *in press*; Wright, Filatotchev, Hoskisson, & Peng, 2005).

2.1. State-owned versus non-state-owned enterprises

The relative advantages and disadvantages of SOEs versus non-SOEs are well documented in the literature. From an economic perspective, transaction cost theory proposes that enterprises exist because they can handle transactions more efficiently than through the market mechanism (Williamson, 1985). In light of this theory, SOEs are inefficient because they include within them transactions that can be better handled by the market. For example, large SOEs undertake policy burdens, such as retaining redundant workers and providing welfare benefits (Lin et al., 1998). They are encouraged to diversify and grow into a mini-society by having their own schools and hospitals. The reform of SOEs hinges on delineating what SOEs should do internally and externally. Through the reform, the more efficient forms of organization will gradually drive out the inefficient SOEs.

In contrast to the economic perspective, the resource-based view suggests that SOEs may have access to certain resources not shared by other firms. For instance, research has long regarded *guanxi* as a key source of competitive advantage in the Chinese context (Tsang, 1998). Although it is argued that personal *guanxi* is more important to

private firms than to state-owned enterprises, this is only true because SOEs have more formal and official network resources than private firms (Peng & Luo, 2000). A notable aspect of such resources is SOE managers' connections to the central ministries (Shenkar, 1990). Because of the short history of China's market economy, the non-SOEs in China generally have not developed rare, valuable, and imperfectly imitable resources, or unique competences, which would help confer a competitive advantage (Barney, 1991; Prahalad & Hamel, 1990).

Finally, institutional theory posits that a firm that conforms to the formal and informal rules, cultural norms, and implicit assumptions of the society is expected to earn legitimacy and social capital, thus enabling it to ensure its own survival, even though it may not be organized in the most efficient way (DiMaggio & Powell, 1983; Scott, 1995). In a transition economy, such as China, socialist values and traditions form part of the formal rules through government directives in economic activities, and part of the informal rules through their influence on managerial practices and routines. For example, retaining an unnecessarily large workforce might be seen as a firm's contribution to the attainment of the central or local government's economic goals. A firm that conforms to such an expectation might be rewarded by access to bank loans and other financial resources, although from a transaction cost perspective, the firm may be close to bankruptcy. In this tradition, SOEs clearly enjoy more legitimacy than their counterparts in the various non-state sectors, and are able to sustain themselves despite economic inefficiencies (Peng & Luo, 2000; Xin & Pearce, 1996).

This analysis points to two different conclusions. While the economic perspective suggests that the SOEs are inefficient and more costly to operate than the non-SOEs, strategy and organization theories suggest that they enjoy resource and legitimacy advantages vis-à-vis the non-SOEs. We summarize these in the form of alternative hypotheses:

Hypothesis 1a. On average, firms in the non-state sectors perform better than state-owned enterprises in China.

Hypothesis 1b. On average, state-owned enterprises perform better than firms in the non-state sectors in China.

2.2. Foreign-invested enterprises versus domestic firms

Transaction cost theory and its extension in the international area, internalization theory, suggest that it

is more efficient (less costly) for a firm to use hierarchies rather than market intermediaries to serve a foreign country (Beamish & Banks, 1987; Buckley & Casson, 1976). In transition economies, FIEs, as the most common form of foreign direct investment, are designed to deal with market imperfections by internalizing business activities that otherwise could be handled by the market (e.g., exporting and importing). They enjoy an advantage over local firms in the form of an internal market within their multinational corporate networks (Ghoshal & Barlett, 1990), which allow them to allocate resources and conduct transactions most efficiently. On the other hand, this organizational form is also associated with increased managerial costs due to such factors as large geographic distances and high demands on information processing.

Resource-wise, the FIEs are able to utilize the ownership advantages of their parent firms in competing with local firms (Dunning, 1981). These may include proprietary assets such as technological know-how and brand names, managerial practices and organizing routines, and strong corporate cultures. Furthermore, multinational firms can gradually develop host-country-specific knowledge through learning from local partners and competitors (Delios & Beamish, 2001). This enlarges the competence gap between foreign and local firms. However, it is hard to determine to what extent these competences have surpassed the local advantages of Chinese firms. As discussed earlier, Chinese firms, especially SOEs, may also enjoy some “network resources” not shared by others because of their *guanxi*.

Multinational firms, as a vehicle that brought advanced technology and management skills to China—as well as contributed to its economic growth—have enjoyed legitimacy to some extent in the past quarter of a century. However, their popularity is declining as Chinese firms seeking growth are facing increasing competition from the multinationals. Furthermore, the legitimacy of FIEs is often affected by political events in the international arena. For example, both American and Japanese firms endured violent attacks by demonstrators at times when the relations between China and these two countries turned sour. The FIEs also suffer from conflicting demands caused by incompatible institutional rules of their home and host-countries (Kostova & Zaheer, 1999; Xu & Shenkar, 2002). Sometimes local legitimacy can only be achieved at the cost of operational efficiency within the multinational firm system (Westney, 1993).

Thus, neither the economic perspective nor the strategy and organization theories can draw clear

conclusions as to the relative advantages of domestic and foreign-invested firms in China. Compared to the local Chinese firms, FIEs are organized and supported by their parents—some of them being the most efficient and resourceful organizations in the world. But they encounter unique information and legitimacy problems in an environment far away from their home countries. We generate two alternative hypotheses based on these differing perspectives:

Hypothesis 2a. On average, foreign-invested enterprises perform better than domestic Chinese firms.

Hypothesis 2b. On average, domestic Chinese firms perform better than foreign-invested enterprises.

2.3. Equity joint ventures versus wholly owned subsidiaries

A long-standing theme in international management is the advantages of equity joint ventures in comparison to wholly owned subsidiaries. The success of EJVs in China has been well documented (Beamish, 1993; Luo, 1997; Pan et al., 1999). In recent years, however, the trend is being reversed. More and more multinational firms have chosen to enter China with WOSs instead of EJVs because of problems associated with the latter. The number of newly established WOSs exceeded that of the new EJVs for the first time in 1997 (Child & Tse, 2001). Among other things, EJVs are plagued by internal conflicts, are hard to sustain, and cannot guarantee access to an administratively divided national market (Walsh, Wang, & Xin, 1999; Vanhonacker, 1997). The business media in China are full of reports on the “equity unilateralization” by the foreign partners in Sino-foreign joint ventures. Even such a pioneer in EJV experiments as Matsushita has bought up the equity stakes of its Chinese partners and formed its wholly owned China headquarters. Such reports, however, are mostly anecdotal and yet to be confirmed through statistical analysis.

The same set of theoretical perspectives we discussed earlier can also provide insights into the relative performance of EJVs and WOSs in the Chinese economy today. The transaction cost–internalization theory has been a dominant paradigm in research on foreign entry mode. This perspective generally favors the EJV as an efficient mode of organizing in an overseas market because it can help address the problems of opportunism and uncertainty associated with international operations (Beamish & Banks, 1987). In a transition economy, costs associated with these problems can be prohibitively high due to the imperfect

market institutions in those countries, thus giving the EJV mode even more advantages than in an average foreign market (Meyer, 2001; Meyer & Peng, *in press*).

The resource-based view suggests that, compared to a WOS, an EJV may benefit from both parents and thus enjoy a higher level of advantage. Combining complementary resources and capabilities has been an important rationale for joint-venture formation. A typical joint venture in transition economies consists of distinctive contributions made by both the foreign and the local parents—usually technological and managerial skills from the foreign parent, and access to distributional channels and markets from the local partner. The success of an EJV often lies in its capacity to absorb knowledge transferred from its foreign parent (Lane, Salk, & Lyles, 2001; Lyles & Salk, 1996), as well as its ability to learn from the local business community (Makino & Delios, 1996). In this sense, an EJV has more resources and opportunities for growth and success than a WOS.

Lastly, institutional theory provides insights into this issue from a non-efficiency perspective. This theory suggests that having a local partner in the host-country is an effective mechanism for lowering the risk of institutional conflicts between a foreign subsidiary and the host-country institutions (Xu, Pan, & Beamish, 2004) and for removing the “liability of foreignness” (Zaheer, 1995). On the other hand, this perspective also suggests that by having two partners within the same organization, there will be a higher probability of intraorganizational conflict between the partners, who may represent conflicting institutional rules and norms, and therefore a higher probability of venture failure (Lu & Xu, *in press*).

While the transaction cost and resource-based theories both favor EJVs over WOSs, the institutional perspective is more ambiguous and provides mixed insights as to which mode may lead to better results. In light of the discrepancy between the general theoretical support for the EJV and the recent tendency among multinational firms to opt for the WOS, we again provide two alternative hypotheses:

Hypothesis 3a. On average, equity joint ventures perform better than wholly owned subsidiaries in China.

Hypothesis 3b. On average, wholly owned subsidiaries perform better than equity joint ventures in China.

3. Method

We relied on two large-sample surveys conducted by the Chinese National Bureau of Statistics to test our

hypotheses. In recent years, the Bureau has gathered financial-statement information annually from domestic and foreign-invested enterprises that had sales revenues of US\$ 25,000 (RMB 200,000 yuan) or above in the past year. In other words, these surveys target all manufacturing firms except very small businesses. By law, all businesses in China are required to cooperate in the surveys conducted by the Bureau. The Bureau started to engage in commercial activities in recent years through its commercial arms. Our data were purchased from one of these firms, Huatongren, which is one of the leading providers of business information in China.

We only used the 1998 and 2002 surveys—the first and last ones for which we have data. The year 1998 marked the twentieth anniversary of China’s reform and open-door policies, and was one year after China started to accelerate the ownership reform (Huang, 2003). From these two samples, we excluded firms that were established in 1998 and 2002, respectively, to make sure that all firms had been in operation for at least one year. We also excluded firms classified as agricultural manufacturers. Further, we deleted cases with obviously inaccurate numbers (e.g., negative sales and negative total assets). There were roughly 140,000 and 160,000 enterprises, respectively, in each of these two samples. Research using this data source has appeared in a number of academic journals (Buckley, Clegg, & Wang, 2002; Pan et al., 1999; Perkins, 1996). As Chow (1993) pointed out, statistics reported by the Bureau are largely accurate and internally consistent for empirical analysis.

We employed multiple-way ANOVA to test *Hypotheses 1a–2b*, using a post hoc procedure (namely, Tamhane’s T2 in SPSS, assuming unequal variance) to derive pair-wise mean differences and their corresponding significance levels. The dependent variables in these tests are three absolute measures, profit, sales, and assets; and three profitability ratios, return on sales (ROS), return on assets (ROA), and profit per employee (PPE).³ The ANOVA tests were conducted among the following groups: state-owned enterprises (SOEs), collectively owned enterprises (COEs),⁴ shareholding enterprises (SHEs), limited-liability enterprises (LLEs), privately owned enterprises (POEs), and foreign-

³ Although we refer to the PPE as a ratio, it is reported as the absolute profit amount per employee.

⁴ Collectively owned enterprises were part of the planned economy in the prereform days. Although this form of ownership has been retained, today’s COEs are part of the market-oriented economy. They include, among others, China’s active township and village enterprises (TVEs).

invested enterprises (FIEs), with age, size, location, and industry as control variables. The control variables were treated as fixed factors along with ownership (hence multiple-way ANOVA); therefore, they are “control variables” only in a conceptual sense. Firm age is measured in years. We evenly divided all firms into four size groups based on the number of employees. Thus, firm size is an interval scale ranging from 1 to 4, with 4 representing the top 25th percentile of firms. Location is a dummy variable coded 1 if a firm is located in a coastal province, and 0 if otherwise. We also included over four hundred four-digit Chinese SICs to control for industry fixed effects. The age, size, and location variables and many of the industry dummies are significant but not reported here.

We then followed the above format to test Hypotheses 3a and 3b, with equity joint ventures (EJVs) and wholly owned subsidiaries (WOSs) as the classification groups. Although there are only two groups involved, we chose multiple-way ANOVA,

instead of a simple *t*-test, because we wanted to “control” for the effects of age, size, location, and industry segments.

4. Results

Tables 1a and 1b list in each cell the mean standard deviation, minimum, and maximum, in that order, of the corresponding dependent variable for the corresponding group. All *F*-tests are significant at the $p < 0.001$ level. Detailed pair-wise results from the post hoc analysis are listed in Appendix A. We discuss the performance of each category of firms below.

4.1. The SOEs

In 1998 (Table 1a), the SOEs had the lowest average profit level (\$1350 US equivalent) among all groups of firms. In terms of profitability, they had a negative and the lowest ROS (−0.246). They were the only group of

Table 1a
Operational performance of all groups of firms in 1998

Dependent variable	SOEs	COEs	SHEs	LLEs	POEs	FIEs	<i>F</i> -test
Profit	1.35 4563 −188,734 697,290	102 758 −49,667 67,016	338 3046 −41,535 189,385	193 4163 −39,459 267,936	84.1 477 −16,887 27,081	214 4802 −108,087 366,954	<i>F</i> = 32.19 <i>P</i> < 0.001
Sales	5872 50,910 25 3599,675	3164 12,717 25 2033,198	5765 25,642 25 1191,277	8201 39,626 25 1535,913	2253 4330 25 157,273	7611 36,210 27 3150,485	<i>F</i> = 35.08 <i>P</i> < 0.001 <i>F</i> = 38.16
Assets	12,968 113,476 12 11300,000	3094 10,680 12 1133,704	8862 41,316 13 2236,054	16,916 93,756 19 2847,927	1785 3942 12 130,134	10,256 51,638 13 3718,626	<i>P</i> < 0.001 <i>F</i> = 228.16
ROS	−0.246 1.560 −97.300 29.900	0.012 0.208 −19.800 7.660	−0.010 1.680 −167.000 7.950	−0.033 0.387 −14.400 2.250	0.026 0.132 −5.730 1.890	−0.030 0.364 −13.500 13.500	<i>P</i> < 0.001
ROA	−0.023 0.164 −7.830 13.900	0.103 0.326 −5.410 19.700	0.050 0.165 −1.190 8.130	0.019 0.110 −1.110 1.990	0.103 0.296 −1.200 16.000	0.023 0.195 −7.140 18.100	<i>F</i> = 997.15 <i>P</i> < 0.001
PPE	−0.206 4.110 −161 367	0.844 3.470 −99 256	0.841 5.850 −36 475	0.509 5.740 −32 357	0.933 2.950 −26 149	0.417 11.000 −676 32	<i>F</i> = 151.63 <i>P</i> < 0.001
<i>N</i>	43,513	43,415	12,322	6164	9138	24,902	

Note: Amounts are in thousand U.S. dollars for all measures except for the ratios. In each cell, the first number is the mean, the second row is the standard deviation, the third row is the minimum, and the fourth row is the maximum.

Table 1b
Operational performance of all groups of firms in 2002

Dependent variable	SOEs	COEs	SHEs	LLEs	POEs	FIEs	F-test
Profit	298	190	627	430	129	664	$F = 28.54$
	6428	1485	7325	4754	599	7559	$P < 0.001$
	-61,457	-4964	-52,016	-134,593	-9117	-91,937	
	581,536	128,166	740,330	382,970	51,591	669,431	
Sales	9973	4194	11,969	10,813	3131	11,487	$F = 32.38$
	98,807	29,583	79,837	60,857	7678	73,414	$P < 0.001$
	25	25	25	25	25	25	
	6033,311	3783,528	4221,264	2924,314	475,501	5666,506	
Assets	18,944	3526	15,339	17,540	2269	11,451	$F = 37.42$
	164,168	22,211	98,656	113,036	6628	56,683	$P < 0.001$
	13	12	28	12	14	13	
	9371,782	2447,658	7688,434	6731,044	482,610	3703,613	
ROS	-0.159	0.021	0.017	-0.001	0.030	0.007	$F = 202.53$
	1.120	0.375	0.307	0.715	0.292	0.350	$P < 0.001$
	-87.900	-42.600	-20.600	-69.200	-58.600	-23.800	
	11.800	2.040	3.560	43.200	2.100	22.400	
ROA	-0.008	0.101	0.053	0.037	0.082	0.046	$F = 298.51$
	0.115	0.283	0.130	0.115	0.172	0.473	$P < 0.001$
	-5.490	-2.400	-4.330	-2.000	-2.270	-56.700	
	4.710	20.900	3.61	3.3	9.760	55.000	
PPE	0.016	1.230	1.360	1.470	1.140	2.200	$F = 42.74$
	5.490	3.700	5.650	35.700	4.100	17.600	$P < 0.001$
	-264	-128	-104	-149	-35	-221	
	334	116	223	4947	337	1926	
N	22,737	24,236	14,836	19,892	44,727	32,751	

Note: Amounts are in thousand U.S. dollars for all measures except for the ratios. In each cell, the first number is the mean, the second row is the standard deviation, the third row is the minimum, and the fourth row is the maximum.

firms that had a negative ROA (-0.023) and a negative PPE (-\$206). By 2002 (Table 1b), their average profit level had risen to \$298,000, surpassing those of the COEs and POEs. Yet their profitability ratios remained the lowest among all firms (-0.159, -0.008, and \$16). The number of SOEs included in the two surveys declined from 43,513 in 1998 to 22,737 in 2002, reflecting the changing reality of the Chinese economy.

4.2. The non-SOEs

The largest group of non-SOEs in 1998, the COEs, did surprisingly well in terms of their profitability ratios (0.012, 0.103, and \$844), and their relative standing remained largely unchanged in 2002 (0.021, 0.101, and \$1230), although their number declined from 43,415 to 24,236. The SHEs had the highest average profit (\$338,000) but a negative ROS (-0.010) in 1998. Their ROA (0.050) and PPE (\$841) were relatively high. The ROS turned positive (0.017) in 2002. It appears that many former SOEs had been transformed into LLEs and POEs

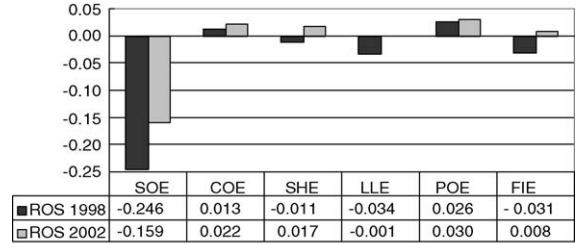
by 2002, as the numbers of these two categories of firms rose substantially to 19,892 and 44,727, respectively. The POEs did rather well in 1998 in terms of profitability. They had the highest ROS and ROA ratios (0.030 and 0.082, respectively) in 2002 as well, although they remained the smallest in size (\$3,131,000 in sales and \$2,269,000 in assets). The LLEs had the lowest performance among the non-SOEs in both years.

4.3. The FIEs

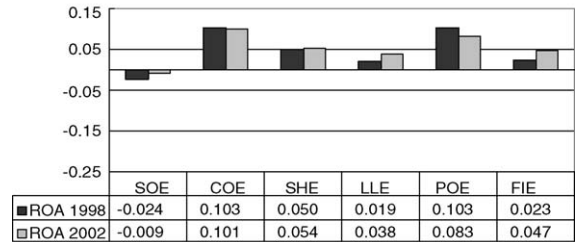
In 1998, the FIEs did not appear to have any significant advantage compared to local firms other than the SOEs. In 2002, they achieved a moderate increase in number (from 24,902 to 32,751), the highest profit level (\$664,000), and the highest PPE (\$2,200). The ROS and ROA ratios (0.007 and 0.046, respectively) both improved over those of 1998 (-0.030 and 0.023, respectively) but still lagged behind some groups of domestic firms. Overall, there is no clear indication that the FIEs performed better than most Chinese firms.

Summarizing the results, combined with a careful examination of the significance levels for pair-wise group mean differences in Appendices A and B, we can draw the following conclusions. First, the SOEs had the lowest performance levels, in terms of profitability ratios, in both 1998 and 2002. Thus, Hypothesis 1a is supported, while Hypothesis 1b is rejected. Second, compared to the non-SOEs, the FIEs performed better than the LLEs only, in terms of ROS and ROA, in 1998. In 2002, the situation was largely unchanged, although the difference between the FIEs and SHEs on ROA turned insignificant (Appendix B). Overall, there are no clear signs supporting Hypothesis 2a. On the contrary, it appears that three categories of Chinese firms—the POEs, COEs, and SHEs—performed better than the FIEs to different extents. Hypothesis 2b received general support.

To better illustrate the above findings, we developed Fig. 1(a and b), depicting results for ROS and ROA, respectively.



(a)



(b)

Fig. 1. (a) Return on sales of all groups of firms: 1998 and 2002. (b) Return on assets of all groups of firms: 1998 and 2002.

Table 2
Operational performance of EJVs and WOSs

Dependent variables	Year 1998			Year 2002		
	EJVs	WOSs	F-test	EJVs	WOSs	F-test
Profit	230	177	$F = 0.73$ $P = 0.394$	746	549	$F = 0.05$ $P = 0.940$
	5015	4286		8921	5098	
	-108,087	-30,626		-91,937	-86,258	
	366,953	315,394		669,431	358,390	
Sales	7618	7594	$F = 2.91$ $P = 0.088$	11,317	11,721	$F = 2.70$ $P = 0.100$
	35,156	38,471		66,144	82,441	
	27	31		25	25	
	3150,485	2196,985		4533,160	5666,506	
Assets	10,705	9249	$F = 5.24$ $P = 0.022$	11,703	11,100	$F = 12.60$ $P < 0.001$
	52,759	49,016		54,697	59,325	
	13	24		13	21	
	3718,626	2478,293		3703,612	3384,195	
ROS	-0.033	-0.024	$F = 0.12$ $P = 0.727$	0.008	0.006	$F = 5.32$ $P = 0.020$
	0.395	0.278		0.379	0.304	
	-13.542	-5.001		-23.830	-16.390	
	4.789	13.482		22.443	5.220	
ROA	0.026	0.015	$F = 26.86$ $P < 0.001$	0.052	0.039	$F = 8.86$ $P < 0.001$
	0.196	0.191		0.421	0.535	
	-3.075	-7.140		-2.471	-56.727	
	18.055	4.653		55.043	9.681	
PPE	0.505	0.219	$F = 0.58$ $P = 0.445$	2.295	2.063	$F = 0.73$ $P = 0.390$
	12.188	7.724		15.130	20.467	
	-676.022	-156.575		-221.266	-125.801	
	325.000	156.221		1165.031	1925.589	
N	17,360	7737		19,120	13,790	

Note: Amounts are in thousand U.S. dollars for all measures except for the ratios. In each cell, the first number is the mean, the second row is the standard deviation, the third row is the minimum, and the fourth row is the maximum.

Finally, Table 2 shows the results of mean comparisons between the EJVs and WOSs. It appears that the EJVs performed better than the WOSs on certain dimensions. In 1998, the EJVs had higher assets ($p < 0.05$) and higher ROA ($p < 0.001$). In 2002, the EJVs stayed ahead of the WOSs on these two measures ($p < 0.001$ for both assets and ROA) as well as on ROS ($p < 0.05$). Differences on other measures are largely insignificant. Hypothesis 3a thus received some support, while Hypothesis 3b received no support. It should be noted that while the numbers of both EJVs and WOS increased during 1998–2002, the latter rose much more rapidly, in both absolute number and percentage.

5. Discussion and conclusions

That domestic Chinese firms are becoming increasingly competitive vis-à-vis multinational firms has received much anecdotal evidence in media and industry reports. A 2002 *Asian Wall Street Journal* article described China's consumer-goods market as characterized by fierce competition and eroding profit margins for small and medium foreign investors, especially because their local Chinese counterparts are gaining competitiveness. The author cited experts from Merrill Lynch and McKinsey to conclude that China is the most competitive (consumer-goods) market in the world (Chang, 2002). Similarly, in a large survey conducted by *Fortune (China)* in 2002, 83% of the responding foreign firms considered increasing competition as a major challenge facing their firms, high over such institutional factors as government relations, labor management, and policy uncertainty (Jiang, 2002).

Our study provides large-sample statistics to confirm these narratives. Three major findings obtained from our data analysis are worthy of further elaboration. The first major finding is that the reformed SOEs and newly formed private firms have become rather competitive compared to the SOEs. After 20 years' reform, the various types of firms into which the former SOEs were transformed—the SHEs, LLEs, and POEs—have achieved evidently higher performance levels than the unreformed SOEs. Although this finding in and of itself is not surprising, this is perhaps the first time that the positive profit outcome of reform in China has been reported on a nation-wide scale.

The second major finding, that many categories of domestic Chinese firms—SHEs, COEs, and POEs—achieved higher performance than the FIEs, is counter-intuitive. Reform and open-door policies began in 1978. Twenty years ago, the performance difference between

Chinese and foreign firms was large. Since then, the domestic firms have made progress through reform and competition, as multinational firms have gradually learned to cope with China's unique institutional setting and competitive environment. While the majority of people in China are concerned about the competitive pressures on domestic firms brought about by the multinationals as a result of China's entry into the WTO, our statistics show that such a concern is perhaps unwarranted. The only groups of domestic firms that lagged behind the FIEs in 2002 were the SOEs and LLEs. This result delivers a clear message; namely, ownership reform is the right way to go for the Chinese economy and should help resolve the controversies on this issue that have existed in China since mid 2004.

Among the non-SOEs, we found the POEs and COEs to be the best performers. This is somewhat surprising because we expected that the SHEs—the firms that most resemble modern corporations in a free economy—to be the leading enterprises in China. From an ownership perspective, however, the SHEs may still involve state equity, in either a majority or minority position. The SHEs and LLEs are the two categories of firms into which the larger SOEs were transformed. The state typically retains some ownership in these firms and exerts substantial influences in the post-reform era. As a result, old cultural problems persist. As these firms are typically larger than the POEs, the government may expect them to share policy burdens, which causes inefficiencies (Lin et al., 1998). If we further consider the fact that some of their best physical and human assets had been separated or spun off to form joint ventures with multinational firms (Buck, Filatotchev, Nolan, & Wright, 2000), then their disadvantages become clear. The POEs, although small, are tightly controlled by private owners and very much profit-oriented. It should not be too surprising that they had the highest ROS in both years. The advantages of COEs, which include numerous township-and-village enterprises (TVEs), have been discussed extensively in the literature (e.g., Che & Qian, 1998; Jin & Qian, 1998) and will not be repeated here.

The last major finding of this study is that the EJVs are still leading the FIEs in terms of profitability ratios. Despite the strategic change made by many multinational firms—incumbents as well as newcomers to China—to opt for WOSs, the EJVs actually had higher performance, based on some measures, than the WOSs, and even more so in 2002 than in 1998. This result, combined with the fact that the FIEs as a whole did not do better than the domestic Chinese firms, has important implications for multinational

firms. It appears that multinational firms today still have a relatively high degree of liability of foreignness in China, and partnering with a local firm remains a good strategy to deal with this situation. In addition to the old argument that a local partner can bridge local knowledge, legitimacy, and consumers to the multinational firm, the higher competitiveness of Chinese firms found in this study suggests that local firms can make further contributions to the success of joint ventures—perhaps in terms of valuable resources and improved capabilities—and that integration within EJV's today will be easier than ever before because of the progress local firms have made in the past two decades or so.

Generally, we send a warning signal to managers of multinational firms inside, or those considering entry into, the China market. It seems that domestic Chinese firms are learning to be efficient competitors faster than the foreign firms. If this trend continues, not only will the FIEs lose ground in China, but their parent organizations also may soon be confronted with a large number of Chinese competitors in markets outside China. The FIEs, of course, still have their traditional advantages in capital, technology, managerial practice, and brand reputation. Furthermore, FIEs had the highest profit level per firm (\$664,000) and the highest profit level per employee

(\$2200) in 2002. With adequate financial resources and excellent training programs, multinational firms can attract, retain, and promote the best talent in China, further strengthening their competitive advantage in the quality of human resources.

Finally, we note that this study has its limitations. Due to data availability, we used only the 1998 and 2002 survey information. Thus, we missed the firms that failed or exited before 1998; those firms included in our analysis may be winners of survival tests over the years. This is a common limitation in research on firm performance, and we were not able to remove this problem. Also, we were not able to identify, among the non-SOEs, the firms that were transformed from former SOEs, and were thus unable to assess the effect of ownership reform directly or conduct a longitudinal analysis. We hope that the inclusion of an age control, and the fact that our empirical analysis was based on two nation-wide, large-sample surveys at two different points in time, will more or less make up for these deficiencies.

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Appendix A. Pair-wise comparisons of performance for different ownership categories in 1998

Ownership (I)	Ownership (J)	Mean difference (I – J)					
		Profit	Sales	Assets	ROS	ROA	PPE
State-owned enterprise (SOE)	COE	–101**	2758***	9994***	–.259***	–.126***	–1.054***
	SHE	–338***	139	4207***	–.236***	–.074***	–1.052***
	LLE	–187**	–2277***	–3879**	–.212***	–.042***	–.714***
	POE	–79***	3676***	11,318***	–.273***	–.127***	–1.144***
	FIE	–213**	–1709***	2804***	–.215***	–.046***	–.633***
Collectively owned enterprise (COE)	SOE	101***	–2758***	–9994***	.2594***	.126***	1.054***
	SHE	–237***	–2618***	–5786***	.023	.052***	.001
	LLE	–85	–5035***	–13,873***	.046**	.083***	.339***
	POE	21***	918***	1324***	–.013***	–.0006	–.090
	FIE	–112***	–4467***	–7189***	.043***	.079***	.421***
Shareholding enterprise (SHE)	SOE	338***	–139	–4207***	.236***	.074***	1.052***
	COE	237***	2618***	5786***	–.023	–.052***	–.001
	LLE	151	–2416***	–8086***	.023	.031***	.338***
	POE	258.59***	3537***	7111***	–.037	–.053***	–.092
	FIE	125***	–1848***	–1402*	.020	.027***	.419***
Limited liability enterprise (LLE)	SOE	187**	2277***	3879**	.212***	.042***	.714***
	COE	85	5035***	13,873***	–.046***	–.083***	–.339***
	SHE	–151	2416***	8086***	–.023	–.031***	–.338***
	POE	107	5954***	15,197***	–.060***	–.084***	–.430***
	FIE	–26	568	6683***	–.003	–.004	.081

Appendix A (Continued)

Ownership (I)	Ownership (J)	Mean difference (I – J)					
		Profit	Sales	Assets	ROS	ROA	PPE
Privately owned enterprise (POE)	SOE	79 ^{***}	–3676 ^{***}	–11,318 ^{***}	.273 ^{***}	.127 ^{***}	1.144 ^{***}
	COE	–21 ^{***}	–918 ^{**}	–1324 ^{***}	.013 ^{***}	.0006	.0903
	SHE	–258 ^{***}	–3537 ^{***}	–7111 ^{***}	.037	.053 ^{***}	.0922
	LLE	–107	–5954 ^{***}	–15,197 ^{***}	.060 ^{***}	.084 ^{***}	.430 ^{***}
	FIE	–133 ^{***}	–5385 ^{***}	–8513 ^{***}	.057 ^{***}	.080 ^{***}	.511 ^{***}
Foreign-invested enterprise (FIE)	SOE	213 ^{***}	1709 ^{***}	–2804 ^{***}	.215 ^{***}	.046 ^{***}	.633 ^{***}
	COE	112 ^{***}	4467 ^{***}	7189 ^{***}	–.043 ^{***}	–.079 ^{***}	–.421 ^{***}
	SHE	–125 ^{***}	1848 ^{***}	1402 [*]	–.020	–.027 ^{***}	–.419 ^{***}
	LLE	26	–568	–6683 ^{***}	.003	.004	–.081
	POE	133 ^{***}	5385 ^{***}	8513 ^{***}	–.057 ^{***}	–.080 ^{***}	–.511 ^{***}

* The mean difference is significant at the 0.10 level.

** Significant at 0.05 level.

***Significant at 0.01 level.

Appendix B. Pair-wise comparisons of performance for different ownership categories in 2002

Ownership (I)	Ownership (J)	Mean difference (I – J)					
		Profit	Sales	Assets	ROS	ROA	PPE
State-owned enterprise (SOE)	COE	100	5580 ^{***}	15,044 ^{***}	–.180 ^{***}	–.109 ^{***}	–1.213 ^{***}
	SHE	–337 ^{***}	–2205	3234	–.176 ^{***}	–.062 ^{***}	–1.339 ^{***}
	LLE	–138	–978	1255	–.158 ^{***}	–.046 ^{***}	–1.456 ^{***}
	POE	161 ^{***}	6649 ^{***}	16,310 ^{***}	–.189 ^{***}	–.091 ^{***}	–1.128 ^{***}
	FIE	–375 ^{***}	–1732	7101 ^{**}	–.166 ^{***}	–.055 ^{***}	–2.185 ^{***}
Collectively owned enterprise (COE)	SOE	–100	–5580 ^{***}	–15,044 ^{***}	.180 ^{***}	.109 ^{***}	1.213 ^{***}
	SHE	–437 ^{***}	–7786 ^{***}	–11,809 ^{***}	.004	.047 ^{***}	–.126
	LLE	–239 ^{***}	–6559 ^{***}	–13,788 ^{***}	.022 ^{***}	.063 ^{***}	–.242
	POE	60 ^{***}	1069 ^{***}	1266 ^{***}	–.008 ^{***}	.018 ^{***}	.084 [*]
	FIE	–476 ^{***}	–7312 ^{***}	–7943 ^{**}	.014 ^{**}	.054 ^{***}	–.972 ^{***}
Shareholding enterprise (SHE)	SOE	337 ^{***}	2205	–3234	.176 ^{***}	.062 ^{***}	1.339 ^{***}
	COE	437 ^{***}	7786 ^{***}	11,809 ^{***}	–.004	–.047 ^{***}	.126
	LLE	198 [*]	1226	–1978	.018 ^{**}	.016 ^{***}	–.116
	POE	498 ^{***}	8855 ^{***}	13,076 ^{***}	–.012 ^{***}	–.028 ^{***}	.211 ^{***}
	FIE	–38	473	3866 ^{***}	.009 ^{***}	.007	–.845 ^{***}
Limited liability enterprise (LLE)	SOE	138	978	–1255	.158 ^{***}	.046 ^{***}	1.456 ^{***}
	COE	239 ^{***}	6559 ^{***}	13,788 ^{***}	–.022 ^{***}	–.063 ^{***}	.242
	SHE	–198 [*]	–1226	1978	–.018 ^{**}	–.016 ^{***}	.116
	POE	300 ^{***}	7628 ^{***}	15,055 ^{***}	–.031 ^{***}	–.045 ^{***}	.327
	FIE	–237 ^{***}	–753	5845 ^{***}	–.008	–.009 ^{**}	–.729
Privately owned enterprise (POE)	SOE	–161 ^{***}	–6649 ^{***}	–16,310 ^{***}	.189 ^{***}	.091 ^{***}	1.128 ^{***}
	COE	–60 ^{***}	–1069 ^{***}	–1266 ^{***}	.008 ^{**}	–.018 ^{***}	–.084 [*]
	SHE	–498 ^{***}	–8855 ^{***}	–13,076 ^{***}	.012 ^{***}	.028 ^{***}	–.211 ^{***}
	LLE	–300 ^{***}	–7628 ^{***}	–15,055 ^{***}	.031 ^{***}	.045 ^{***}	–.327
	FIE	–537 ^{***}	–8381 ^{***}	–9209 ^{***}	.022 ^{***}	.036 ^{***}	–1.057 ^{***}
Foreign-invested enterprise (FIE)	SOE	375 ^{***}	1732	–7101 ^{***}	.166 ^{***}	.055 ^{***}	2.185 ^{***}
	COE	476 ^{***}	7312 ^{***}	7943 ^{***}	–.014 ^{***}	–.054 ^{***}	.972 ^{***}
	SHE	38	–473	–3866 ^{***}	–.009 ^{**}	–.007	.845 ^{***}
	LLE	237 ^{***}	753	–5845 ^{***}	.008	.009 ^{**}	.729
	POE	537 ^{***}	8381 ^{***}	9209 ^{***}	–.022 ^{***}	–.036 ^{***}	1.057 ^{***}

* The mean difference is significant at the 0.10 level.

** Significant at 0.05 level.

***Significant at 0.01 level.

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