Management and Organization Review 1:2 303–307
1740-8776

Is China for Sale?

Marshall W. Meyer
The Wharton School, University of Pennsylvania, USA

Yasheng Huang's *Selling China: Foreign Direct Investment during the Reform Era* is the first book to be reviewed in *Management and Organization Review*. Other books bearing on Chinese management that the editors judge to be significant and provocative will be reviewed on an ad hoc basis. *Selling China*, to be sure, is not about the practice of management in China. Rather, it is about the policies that have created two economies and two managerial systems in China, one domestic and one foreign-invested, and the consequences of these policies. The existence of these two economies and managerial systems lurks in the background of virtually all management research in the Chinese context.

Selling China is both significant and provocative. It is significant because the flow of foreign investment into China is, if anything, accelerating, US$13.4 billion in the first quarter of 2005 or 9.5% above the corresponding period in 2004 according to the Xinhua News Agency (14 April 2005). The Ministry of Commerce estimates China's 2004 FDI to have exceeded US$60 billion or about 4% of GDP, the latter nearly half the growth of the Chinese economy. Should China's inbound FDI suddenly halt or even plateau, growth would stall with dramatic economic and political consequences. *Selling China* is provocative because Huang's thesis is unusual: FDI has drawn to China because the domestic private sector has been suppressed by policies favouring the state sector.

> FDI financed efficient private entrepreneurs and alleviated China's inefficient political pecking order of firms. FDI also supplied a privatization function on a greater scale than otherwise would have been politically feasible . . . If privatization of SOEs had been politically feasible, or if private entrepreneurs could have obtained financing to fulfill export contracts, many of the benefits currently associated with FDI could have been realized with a lower level of FDI in the Chinese economy (p. 97).

© Blackwell Publishing Ltd 2005. Published by Blackwell Publishing, 9600 Garsington Road, Oxford, OX4 2DQ, UK and 350 Main Street, Malden, MA 02148, USA.

https://doi.org/10.1017/S1740877600001133 Published online by Cambridge University Press

The tone of *Selling China* is scholarly. Huang tries to maintain a neutral stance, especially toward the impact of FDI, throughout. However, toward the end Huang is harshly critical of an official ideology which, he believes, has impeded growth of the private sector and driven reliance on FDI: 'Chinese policy makers have not endorsed a large-scale privatization strategy because they want to preserve socialism . . . Ideology . . . may provide the single best explanation as to why China has not chosen a privatization path' (p. 345).

The three reviews in this symposium present somewhat different perspectives on Huang's thesis that FDI is drawn to China because the private sector has been starved of capital. Beamish and Delios argue that discrimination against the private sector has abated somewhat since Huang conducted the bulk of the research reported in *Selling China*. Indeed, based on the declining performance of Japanese-owned subsidiaries operating in China from 1992 to 2001, Beamish and Delios believe that hypercompetition will force many foreign-invested companies out of the Chinese market, making room for a vibrant domestic private sector. Shenkar criticizes Huang for inattention to the non-economic consequences of FDI and, in particular, the transfer of technology and tacit knowledge from foreign to domestic joint-venture partners. Shenkar argues that FDI-facilitated technology transfer will ultimately strengthen Chinese firms and render many of them globally competitive. Overholt agrees with Huang's analysis of the Chinese financial system as driven by a political pecking order favouring inefficient SOEs over the private sector. But he rejects Huang's argument that distortions in the financial sector account for the huge inflow of FDI into China. Overholt argues, rather, that China's competitiveness and dynamism attract FDI: foreign firms invest in China because of perceived opportunities, not distorted institutions. Overholt, paralleling Beamish and Delios as well as Shenkar, argues that FDI has improved the managerial, marketing, and technological capabilities of Chinese joint venture partners to the point where domestic firms are beginning to retake the market.

In one way or another, the reviewers, especially Shenkar and Overholt, are saying that the Huang's argument is overstated, that FDI is a sign of health rather than a Band Aid for flawed institutions. But perhaps Huang's argument is understated and a stronger hypothesis should be considered, namely that the inflows of FDI needed to jump start China's growth engine will eventually pose a challenge for China's firms and its economy. Let us start with a couple of economic factoids. One is the valuation of the RMB vis-à-vis the US dollar. Given China's huge trade surplus (with the USA – not Asia), huge US dollar reserves, and booming economy, some appreciation of the RMB against the dollar would be natural. Recall that a little over a decade ago, the RMB was devalued 40% to pull China out of a recession. However, the Chinese government resists revaluation because it would have several negative consequences. Revaluation would crimp the inflow of FDI by making Chinese assets more expensive. And it would accel-

© Blackwell Publishing Ltd 2005.

https://doi.org/10.1017/S1740877600001133 Published online by Cambridge University Press

erate the flow of Chinese assets abroad, even though capital accounts remain non-convertible, threatening the liquidity of the commercial banks that are insolvent because of non-performing loans to SOEs. If China were not dependent on FDI to fuel economic growth and on currency controls to keep the banks liquid if insolvent, would it not seek rather than resist RMB revaluation? Another economic factoid is the FDI-dependence of China's export economy. According to the PRC Ministry of Commerce, exports from China totaled US$561 billion in 2004, up from US$359 billion in 2003 and more than one-third of 2004 GDP. Nearly 60% of 2004 exports, US$325 billion, were from foreign-invested companies. Could China's SOEs, which accounted for US$176 billion or 31% of exports in 2004, take up the slack were FDI growth to falter? They could only if they became more competitive. Could the private sector? In the short term, this is less likely because in 2004 the private sector accounted for only US$42 billion or 7.5% of Chinese exports.

The overriding issue, then, is the impact of FDI on the competitiveness of domestic firms on which China's prosperity will ultimately depend. Beamish and Delios, Shenkar, and Overholt all believe that FDI improves the capabilities of domestic firms through transfer of technology and know-how from foreign partners. This is an assumption, and may not be accurate in all instances. In one instance it is not. The firm is the Beijing Instrument Industry Holding Company (BIIH), a municipally-owned SOE. BIIH operates in six related businesses: automated control systems for industry, scientific instruments, control systems for electrical generation and distribution, environmental measurement and analysis, digital optics, and solar energy. The total sales are about RMB3.66 billion or US$440 million. BIIH's subsidiaries include eighteen domestic shareholding companies, four research institutes, and thirty foreign joint ventures. The joint venture partners include global firms such as ABB, Emerson Electric, and Olympus. Today, the joint ventures account for 79% of BIIH's sales and 94% of its profits, up from 32% of sales and 51% of profits ten years ago. Importantly, joint venture dominance of BIIH occurred rapidly. In 1998, BIIH's joint ventures accounted for 38% of sales and 59% of profits. By 2001, the joint-venture percentages of total BIIH sales and profits were 63% and 96%, respectively.

The superior performance of BIIH's joint ventures in comparison with domestically-owned subsidiaries may be as a result of better management, but it is partly as a result of government policies favouring foreign joint ventures in two domains, taxation and employment. The tax rate for domestic firms, SOEs included, is 33%, but it is 24% for firms with foreign investment. Moreover, foreign firms are more likely than domestic firms to be treated as high-technology companies, which are afforded a three-year tax holiday and taxed subsequently at a rate of 15%. Legislation to equalize income taxes for domestic and foreign firms was to have been introduced at the recent session of the National Peoples Congress but was dropped at the last minute. SOEs and their domestic subsidiaries, additionally, are disad-

© Blackwell Publishing Ltd 2005.

https://doi.org/10.1017/S1740877600001133 Published online by Cambridge University Press

vantaged in managing people: the *danwei* (work unit) system imposes enormous social overhead costs, including lifetime employment, while salaries of SOE managers and technical personnel are restricted by government pay scales. Foreign joint ventures, by contrast, are not burdened by social overhead costs, can offer competitive wages, and can lay people off at will.

The profitability of BIIH's foreign joint ventures would be a good thing for China if BIIH or other Chinese owners retained control of and hence the capability to learn from the joint venturess. In fact, control of the joint venturess has been largely ceded to BIIH's foreign partners. In some instances, the foreign partner negotiated a controlling interest as a condition of establishing the joint venture; in most instances, however, the foreign partner demanded and was granted a controlling interest as a condition of continuing the joint venture once it became profitable. To illustrate: prior to 2001, BIIC and one of its partners each had a 50% stake in a joint venture manufacturing electrical control systems. In 2001, the partner threatened to bolt, and demanded and received 51% ownership, following which the joint venture began competing with BIIH's domestically-owned subsidiaries. As the three reviews of *Selling China* point out, the consequences of foreign control of subsidiaries may be insignificant in comparison with the long-run benefits of knowledge transfer to the parent company and host country. In this regard, BIIH's recent experience has been dismal. According to its managers, BIIH received nearly 100 transfers of technology from 1980 through 1989 but fewer than ten transfers from 1990 to 2004. Most of these technology transfers were licensed from third parties rather than joint venture partners; the sharp decline in technology transfers occurred mainly because of tighter US controls of technology exports and higher licensing fees. Importantly, while technology transfers to BIIH plunged, the leakage of know-how from BIIH to its joint venture partners accelerated as its best people were recruited into foreign joint ventures. At some point, of course, some leakage of know-how from foreign joint ventures to the domestic economy will occur as people leave joint ventures to set up their own entrepreneurial ventures.

I am not sure whether the experience of BIIH is at all representative of Chinese SOEs and their foreign joint ventures. I am fairly certain, however, that Chinese policy has favoured foreign investment and that firms with foreign investment, in turn, have exploited this advantage vis-à-vis the private sector *and* SOEs. It may be, of course, that China's distorted financial system has disadvantaged private firms even more than SOEs. Still, the proximate cause of the massive inflow of FDI into China is government policies, particularly tax and employment policies, favouring foreign over domestic firms. There are different explanations for preferential treatment of foreign firms. One is deference to foreigners. A senior official of the State Council has told me that foreigners are always privileged in Chinese culture: 'Why else would China open the best land with the best labour force and then offer the most favourable tax rates to foreign investors?' I cannot

© Blackwell Publishing Ltd 2005.

https://doi.org/10.1017/S1740877600001133 Published online by Cambridge University Press

vouch for a cultural explanation, but it came from a person with a deep understanding of Chinese culture and the Chinese economy. Another explanation is ready cash. Opening China to foreign investment and favouring foreign investors was the quickest way to inject large amounts of cash into an otherwise poor society. As a Shanghai entrepreneur put it, 'It's free money'. Whether FDI is the best way to create enduring wealth is another matter: the worry is that China, like BIIC, may become hooked on FDI and lose control of its economy.

The challenge for management researchers, then, is to get inside firms like BIIC and understand the flows of resources, technologies, and know-how, and ultimately the balance of power between parent companies and their foreign joint-venture partners. Until we understand these processes at the firm level, we will not fully understand the impact of FDI on the viability of Chinese firms and China's overall economic wellbeing. Doug Guthrie's 'Organizational Learning and Productivity: State Structure and Foreign Investment in the Rise of the Chinese Corporation' in this issue of *Management and Organization Review*, in fact, goes inside firms to understand the full impact of FDI. Among other results, Guthrie finds higher productivity in foreign-invested firms than in firms without foreign contact.

Yasheng Huang and the reviewers are to be congratulated for drawing attention to the extraordinarily complicated and highly significant issues surrounding foreign direct investment in China. We hope that this symposium stimulates others to follow their lead by probing the impact of FDI on Chinese firms and that *Management and Organization Review* will be able to publish this work in the near future.

Marshall W. Meyer (meyer@wharton.upenn.edu) is Richard A. Sapp Professor and Professor of Management and Sociology at the Wharton School of the University of Pennsylvania.

© Blackwell Publishing Ltd 2005.

https://doi.org/10.1017/S1740877600001133 Published online by Cambridge University Press