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for Doing Business in the GPRD,
China — Evidence from Hong Kong
Electronics SMEs**

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The Role of Personal Relationships for Doing Business in the GPRD, China – Evidence from Hong Kong Electronics SMEs

Frank Bickenbach and Wan-Hsin Liu

Abstract:

This paper investigates the role of personal relationships for doing business in the Greater Pearl River Delta, China. First, it discusses the interplay of formal and informal (relationship-based) institutions from the point of view of institutional economics, with a focus on economies with weak formal contracting and property rights institutions. Second, it describes the institutional environment for doing business in China, and in the PRD in particular. Third, it uses data obtained from a survey among executives of Hong Kong electronics SMEs with business operations in the PRD to gain insights into their perceptions on the importance and the motives of using personal relationships for business in PRD in general, and on the impact of personal relationships on different strategic business decisions (on location, partner, and formal governance structures) for companies' production as well as innovation activities. The results confirm the importance of personal relationships for doing business in the PRD, in general. There is evidence of substantial differences as to the role of personal relationships between production and innovation activities.

Keywords: personal relationships, formal and informal institutions, production, innovation, China, company survey

JEL classification: L20, L63, P0

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1 Introduction

Since the beginning of the open-door policy in 1979, China has recorded very high economic growth rates and developed into one of the three largest economies in the world (World Bank, 2009). Foreign direct investments have been playing an important role in this process (e.g., Wei, 1996; Graham and Wada, 2001; Zhang, 2001).¹ A large number of foreign Asian as well as Western companies have relocated, mainly labor-intensive, production activities to China, allowing them to benefit from China's huge low-cost labor-force. These large foreign investments were made despite a continuing weakness of formal (legal and economic) institutions and often stressed social and cultural differences of doing business in China. Among these differences, the importance and pervasive use of "guanxi" (关系) in daily social and business life in China has been especially emphasized. Guanxi "refers to the concept of drawing on established connections in order to secure favors in personal relationships". It has been argued that the guanxi is indigenous to Chinese culture and deeply rooted in its Confucian legacy (Dunning and Kim, 2007).

The (alleged) importance of guanxi for doing business in China has attracted considerable attention among researchers. Since the 1980s, there has, in particular, been a growing business and management literature that tries to clarify the role of guanxi for doing business in China (Fan, 2002). Most of the empirical studies of that literature are based on surveys among Chinese managers or foreign managers with some experience in Chinese business (e.g., Xin and Pearce, 1996, Davies et al., 1995, Luo 1997; Park and Luo 2001). Generally, the survey results confirm the importance (in the view of the managers surveyed) of guanxi with other managers and/or with government officials. In general, guanxi is found to lead to better firm performance—in at least in some, but not necessarily all, performance dimensions.² Langenberg (2007) and Luo (2007) summarize the empirical literature on the importance of guanxi and its effect on business performance.

¹ Over time, China has become one of the most important destinations of cross-border investments worldwide. Since 1993 it has even received the greatest amount of foreign direct investments among all developing countries (Long, 2005).

² Park and Luo (2001), for example, find that guanxi has a positive effect on sales growth but not on profit growth.

Overemphasizing the culture-determined characteristics of guanxi may result in a systematic bias in assessing the importance of personal relationships for doing business both in China and in other emerging and developing economies. Chinese and foreign firms in China may use personal relationships for governing business transactions not only for cultural reasons but also because of the benefits it provides in a business environment characterized by weak formal institutions of (legal) contract enforcement and property rights protection. Personal relationships and networks may serve as a substitute for deficient formal institutions of information provision, contract enforcement and property rights protections. The cultural motive and the institutional motive for using personal relationships may have widely different implications for the future role of personal relationships for business in China (and possibly other emerging economies). If we expect market oriented reforms in China to continue and to further improve formal market institutions and the functioning of the legal system, the predominance of the institutional motive would predict a declining importance of business relationships, while the cultural motive would suggest that the role of guanxi will remain essential in China.³ More generally, the two motives may have different implications for companies' choice of formal governance structures and their interplay with informal (relationships-based) institutions.

This paper aims to provide some insights into the motives behind companies' use of personal relationships for doing business in China as well as into the importance and the implications of personal relationships for different strategic business decisions (location and partner choice, and choice of formal governance structures for companies' production as well as innovation activities). We present the institutional economics perspective on the role and the interplay of formal and informal (relationship-based) institutions in governing business exchange and empirically scrutinize some of its theoretical suppositions. Our empirical analysis is based on an original firm-level data set derived from a 2007 survey among leading executives of Hong Kong based, small- and medium-sized enterprises (SMEs) of the electronics industry, that are operating in the Pearl River Delta (PRD) in 2007.⁴

³ In the following, we will mostly use the „culturally more neutral“ term personal relationships instead of guanxi (with some exceptions in Section 3.2).

⁴ The Pearl Rier Delta (PRD) comprises nine municipalities of the Chinese Province of Guangdong (Dongguan, Foshan, Guangzhou, Huizhou, Jiangmen, Shenzhen, Zhaoqing, Zhongshan, and Zhuhai). The PRD and adjacent Hong Kong and Macao Special Administrative Regions together consititute the Greater Pearl River Delta (GPRD).

The rest of the paper is organized as follows. Section 2 describes the institutional economics view on the interplay of formal and informal (relationship-based) institutions in governing business exchange. Section 3 describes the current institutional environment for doing business in China. Section 4 briefly introduces the background of the HK company survey through which the data set was obtained. Section 5 presents the results of the empirical analysis. It presents our results on the general importance of personal relationships with private business and with public officials for doing business in the PRD and the general motives behind the companies' use of personal relationships (Section 5.1); the importance of personal relationships, relative to other decision criteria, for the companies' location and partner choice for both production and innovation activities (Sections 5.2); and the relationships between companies' use of personal relationships and their choice of formal governance structures for production and innovation activities (Section 5.3). Section 6 concludes.

2 Institutions: Theoretical Background

2.1 Institutional Environment and Institutional Change

Institutions, i.e. rules and instruments to enforce these rules, matter for the efficiency of human exchange (North, 1990).⁵ By defining and protecting property rights, enforcing contracts, and providing reliable information, well functioning (economic) institutions can reduce the risks and transaction costs of investment and exchange. Economic activity is supported and shaped by both informal and formal institutions. Informal institutions include the social and religious norms and taboos, the mores, traditions and codes of conduct and the social networks that exist in a society. Formal institutions include political, judicial and economic rules, ranging from (written) constitutions, statutory laws (civil and commercial codes, criminal codes) to specific regulations and bylaws and to (individual) contracts (North, 1990: 36, 47).⁶

⁵ Institutions have been variously defined. According to North (1990: 3) „institutions are the rules of the game in a society, or more fundamentally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social or economic”. In addition to this view of institutions as the rules of the game there is also the view of institutions as the outcome of a game, i.e. as endogenously appearing self-enforcing rules that are the outcome of a repeated game (see, e.g. Aoki 2001).

⁶ More explicitly, one may define formal institutions as rules that are readily observable through written documents and executed through formal positions, while informal institutions may be defined as rules based on implicit (or at

In analyzing institutions and their effects on economic activity and performance it is useful to follow Davis and North (1971) and distinguish between two levels of institutions, the institutional environment and institutional arrangements (or governance structures). The institutional environment is the overarching framework of rules and constraints, both formal and informal, that define the context in which economic activity, or social interaction more generally, takes place. It encompasses the political, social and legal ground rules that establish the basis for production, exchange and distribution (Williamson, 1996: 378). Within this overarching framework, parties to a specific exchange set up institutional arrangements, i.e., formal and informal (micro-level) rules and forms of contracts, that govern the way in which they cooperate and/or compete (Williamson, 1996: 378).

Two elements of the institutional environment, in particular, are generally considered to be of great importance for the level and the organization of economic exchange of an economy: “contracting institutions” and “property rights institutions” (Acemoglu and Johnson, 2005).⁷ Contracting institutions are the rules that support the conclusion and the enforcement of contracts between (private) economic agents, e.g. between a creditor and a debtor or between a supplier and its customer (Acemoglu and Johnson, 2005: 955). Differences in contract laws and their implementation across countries introduce significant differences in the costs of enforcing contracts and consequently in equilibrium contracts and transactions. Property rights institutions are the rules that protect the assets (and the returns to the assets) held by economic agents against expropriation by others, in particular, against the coercive power of the government and politically powerful elites (Acemoglu and Johnson, 2005: 955; Greif, 2005: 728). In contrast to contracting institutions, property rights institutions mainly relate to the interactions between private economic agents and state actors. They determine the degree to which the government and other powerful elites are constrained in their relationships with the rest of the society. They do not only affect the risk of direct government expropriation of private property but also the level to which regulations and public decisions determine a level playing field for all economic actors or favor and protect a small elite with close relationships with the government. In doing so

least unwritten) understandings, which are in most part socially derived and are therefore not accessible through written documents or necessarily sanctioned through formal position (Zenger et al, 2002: 278).

⁷ Or “contract enforcement institutions” and “coercion constraining institutions” in the terminology of Greif (2005).

they also affect the level of corruption and more generally the balance of diversionary (rent-seeking) and productive activities in society.

There are substantial differences between societies in the nature and sophistication of their contracting and property rights institutions and in the degree to which they are able to reduce the transaction costs and the risks associated with economic exchange and investments in private assets. In Western societies, over time, complex formal (legal and political) institutional structures have been devised to enforce contracts and protect property rights. Some of these institutional structures are non-existent, weak or poorly devised in less developed countries (Bardhan, 2005: 512). Acemoglu and Johnson (2005) found robust evidence that the strength of property rights institutions has a significant positive influence on major economic outcomes, including long-run economic growth (per-capita income), the ratio of investment to GDP, and the level of credit and stock market development. By contrast, they found no evidence that weak contracting institutions have a significant negative effect on long-run economic performance. Contracting institutions appear to affect the form of financial intermediation (stock market capitalization) but have limited or no (statistically significant) effect on growth, investment, and the total amount of credit in the economy. “It seems that economies can function in the face of weak contracting institutions without disastrous consequences, but not in the presence of a significant risk of expropriation from the government or other powerful groups” (Acemoglu and Johnson, 2005: 953). As a possible explanation for their results Acemoglu and Johnson (2005) suggest that there is a fundamental difference in the options that are open to individuals affected by weak contracting institutions and those affected by weak property rights institutions. Individuals may generally be able to alleviate the problems originating from weak contracting institutions by altering the terms of their formal and informal contracts or by developing relation- or reputation-based mechanisms to enforce their agreements. After these adjustments have been made, the effects of contracting institutions on investments and growth are apparently relatively limited. When property rights institutions fail to protect citizens, such solutions may be more difficult and individuals may find it much harder to mitigate the risk of expropriation by the state and powerful elites in this way (ibid.: 984, 988). In the view of Acemoglu and Johnson (2005:

988) enforceable contracts between individuals and the state to constrain future actions by the state “are not possible”.⁸

Establishing informal relationships with government officials to alleviate the problems originating from weak property rights institutions may be more difficult for individuals than establishing personal relationships with private exchange partners. But it is certainly not impossible. The main difference between weak contracting institutions and weak property rights institutions as to their effect on long-term growth and efficiency may rather be that informal relations between citizens and public officials may often be discriminatory and may restrict rather than foster market entry and exchange (and thus overall growth). Economic actors may use informal, relation-based agreements with public officials not only to get protection and support for their own business but also to obstruct potential competitors.⁹

It is widely recognized that the importance and the relative efficiency of formal institutions and rule-based systems governance increases relative to that of informal institution and relation-based systems of governance as the scope of market exchange broadens and deepens (Rodrik, 2005:1005; North 1990; Li 2003; Li et al. 2004; Dixit 2004). Relation-based governance systems based on voluntary information flows and self-enforcing equilibrium work well in small or/and well-knit groups, whereas large groups need more formal institutions for information dissemination and enforcement. When the scale and scope of an economy is small, relation-based governance will generally be less costly than rule-based governance. At the aggregate level relational governance is associated with comparatively low fixed costs as it avoids the high fixed costs of developing elaborate formal institutions of information verification and legal contract enforcement. At the level of individual exchanges, parties with pre-existing social and personal relationships will find relational governance to be less costly as it saves the legal enforcement and public information and verification costs of rule-based governance (Li 2003, Li et al. 2004,

⁸ “When property rights institutions fail to constrain those who control the state, it is not possible to circumvent the ensuing problems by writing alternative contracts to prevent future expropriation, because the state, with its monopoly of legitimate violence, is the ultimate arbiter of contracts” (Acemoglu and Johnson, 2005: 951).

⁹ Discussing the case of China, for example, Li (2004: 110) argues that good personal relations with local governments are vital for firm operation and performance in China, Firms that have a good relationship with government may use it for their advantage to reduce the risk of expropriation. Economic agents with strong relationships with government officials may also use these relationships, however, to expropriate agents with no or weaker relationships (for examples, see Li, 2004).

Dixit 2004 chapter 3). At the same time, however, relational governance exhibits comparatively high marginal costs (particularly of private monitoring and contract enforcement) of extending business as this involves parties with successively weaker relational links. Therefore, as an economy expands in scale and scope, relying on personal relations to govern business interests becomes increasingly costly. Restricting the choice of business partners to pre-existing networks may foreclose the choice of the most efficient trading partners or the most efficient locations for doing business and may inhibit potentially profitable transactions with people outside the network (Bardhan, 2005: 514). A rule-based governance system, in contrast, requires a high fixed cost to establish the necessary legal and informational infrastructure but comparatively low marginal costs of enforcing contracts and doing business with strangers. As the scale and scope of the economy increases, the benefits of a rule-based governance system (in terms of lower marginal costs) rise and the fixed costs of establishing such a system can be spread over a larger number of transactions. According to this institutional logic, societies could be expected to be more likely to develop an institutional environment supporting rules-based governance as their economies expand in scale and scope.¹⁰ Once such an institutional environment is established, economic agents can be expected to increasingly rely on formal institutions and rule-based governance mechanisms to govern their economic exchanges.

Institutional change in general and the change of the basic institutions of the institutional environment in particular are often quite slow, however. This is true in particular for informal institutions. The basic informal institutions that exist in a society are often cultural, religious or moral in origin. Due to this origin they possess inertia that slows the pace of change and gives it a continuous and gradual character (Zenger et al., 2002: 283-4). The basic formal institutions of a society generally also tend to be quite persistent and their change mostly incremental.¹¹ Occasionally, however, windows of opportunity arise in which formal institutions can change very fast and in large discrete steps (North, 1990: 89; Williamson, 2000).¹² Even the effects of

¹⁰ China's economic and legal reform process (see Section 3) may be described as a gradual transition from a relation-based to a rule-based governance system (Li, 2004: 114, also see Li et al., 2004)

¹¹ Even welfare enhancing reforms of formal institutions are generally quite difficult to accomplish. They are associated with high fixed costs and require substantial efforts to solve coordination problems and overcome the objections of those who benefit from existing institutions (North, 1990: 89-91).

¹² Natural disasters, (civil) wars or occupations, perceived threats, economic breakdowns or financial crises can provide such opportunities (North, 1990: 89; Williamson, 2000).

such broad and fast changes of formal institutions may be limited by tensions between the new formal rules and existing informal rules that cannot be changed by fiat and respond only gradually and slowly to changes in the formal institutions (North, 1990: 91; Zenger et al., 2002: 283-4). These tensions may undermine compliance with formal rules and may create a lag between the implementation of new formal institutional structure and the change in its overall functionality, which derives in large part from complementary informal institutions (ibid.). These lags may be quite long as even informal institutions that are in conflict with the formal institutions may have great survival tenacity if they are deeply enshrined in cultural traditions. Simply, issuing new (“Western-type”) contract laws and property rights laws may thus not be sufficient to guarantee effective legal contract enforcement by courts and an effective protection of assets against expropriation by government. And even if the formal institutions of contract enforcement and property rights protection work reasonably well, persistent cultural norms and informal constraints may still induce economic agents to stick to use informal relation-based mechanisms of governance. This is true, in particular, where their efficiency costs relative to formal rule-based forms of governance are not too large and competitive pressures are not too strong.

In any case, the spread of formal, rule-based forms of governance does not imply the (complete) disappearance of relation-based forms of governance. The dichotomy between formal or rule-based governance systems and informal or relations-based governance systems is merely theoretical. In reality, most systems contain element of both forms of governance (Dixit, 2004: 25, 83; Li, 2003: fn5). In particular, even in the most developed economies, where well-functioning formal institutions of legal contract enforcement exist, formal institutions rarely govern all detailed aspects of economic exchanges. Informal arrangements and elements of relation-based governance continue to play an important role for most transactions between as well as within firms.

2.2 Institutional Arrangements: Formal and Informal Elements

Within the framework given by the institutional environment economic actors develop and implement specific institutional arrangements (governance structures) for carrying out specific transactions (Williamson, 1996: 111-2, 378; Davis and North, 1971). The comparative efficiency

and the choice of alternative governance structures have been extensively studied within the New Institutional Economics (NIE) in general, and Transaction Costs Economics (TCE) in particular (e.g., Williamson, 1996; Ménard, 2005). TCE focuses on the specific features of transactions, the nature and size of the transaction costs, and on the way different institutions affect these transaction costs.¹³ It works out of the hypothesis that transactions, which differ in their characteristics and related exchange hazards, are aligned with governance structures, which differ in their instruments and performance attributes, in a discriminatory, mainly transaction cost minimizing way (Williamson, 1991; 1996: 46-47, 105). While TCE generally accepts the importance of the institutional environment and the role of informal institutions of governance, its main focus has been on the determinants of *formal institutions of governance* in economies with a *well developed (Western-type) institutional environment*.

For private business transactions three discrete structural governance alternatives are commonly recognized (Williamson, 1991; 1996: 378): *markets*, in which autonomous parties engage in exchange; *hierarchies*, in which transactions are placed under unified ownership; and *hybrid* contracting, which preserves the parties' autonomy but adds contractual safeguards and increases information disclosure. Examples of hybrid governance are complex long-term contracting, strategic alliances and joint ownership arrangements. The alternative modes of governance—market, hybrid, and hierarchy—differ with respect to a number of instruments and performance attributes. According to Williamson (1991, 1996: 102-105) crucial differences exist, in particular, in the use of incentives and control instruments (“incentive intensity” and “administrative controls”) and in the ability to adapt to unforeseen contingencies in an autonomous or a coordinated way. Markets are characterized by the use of strong incentives and weak administrative controls; they perform strongly in autonomous adaptation but weakly in coordinated adaptation. For hierarchies the situation is exactly the opposite: they are characterized by weak incentives, strong administrative controls, weak autonomous adaptation and strong coordinated adaptation. Hybrid governance structures are located between the two polar cases in all attributes—“semi-strong” (intermediate) incentive intensity, administrative controls, and

¹³ Transaction costs include *coordination costs*, i.e., the costs of acquiring, transmitting and processing information, as well as *motivation costs*, i.e., the costs of securing incentive compatibility on the side of the transacting parties (Milgrom and Roberts, 1992: 25, 29–30). In a generalized meaning, they include both the direct costs of carrying out a transaction and the opportunity costs incurred when an efficiency-enhancing transaction is not realized (ibid. 604).

adaptability of both kinds (Williamson, 1991; 1996: 105).¹⁴ Given the differences in instruments and performance attributes of the different governance modes the transaction cost minimizing choice between alternative governance structures involves a trade-off between the protection against the hazards related to opportunistic behavior of transaction parties on the one hand and the ability to flexibly adjust to unforeseen or changing contingencies on the other. This trade-off, and thus the comparative efficiency of the different governance structures, depends on the characteristics of the transaction being conducted.

Critical dimensions with respect to which transactions differ include in particular, the degree of asset specificity involved in supplying the good or service in question, the severity of behavioral uncertainty and the degree of environmental uncertainty. *Asset specificity* generally refers to a durable investment in physical or human assets that is undertaken in support of a particular transaction (such as the sourcing of a particular input), with the productive value of the investment being much lower in the best alternative use should the original transaction be terminated prematurely (Williamson, 1996: 105, 377). *Behavioral uncertainty*, also referred to as *measurements problems*, relates to informational problems of determining (specifying or programming) the actions undertaken by transacting parties and how these actions affect subsequent outcomes. Behavioral uncertainty can arise both ex ante and ex post to an agreement. Ex ante there may be problems of ascertaining the competence (or the reliability) of potential trading partners or of the quality of the products/services they offer. Ex post, after concluding an agreement it may be costly to measure and verify the performance of trading partners. *Environmental uncertainty*, finally, arises because potential transaction partners cannot foresee and describe all possible future states of the environment that are relevant for their exchange, such as conditions on input or output markets or the available technology. The transacting parties will thus be unable generally to write (enforceable) contracts that account for all future contingencies and describe efficient state contingent terms of exchange. Therefore, as the exchange relationship unfolds and unforeseen or unaccounted-for changes in the environment occur, the transacting parties will have to adapt the terms of their original agreement. Environmental uncertainty thus leads to increased costs of communication, negotiation and

¹⁴ The different modes of governance are also differ in contract enforcement procedures used and, in particular, in the role of courts in contract enforcement (Ménard, 2000; Williamson 1991; 1996: 95-100).

coordination (direct transaction costs) as well as costs due to mal-adaptation or failures to adapt to unforeseen contingencies (opportunity transaction costs).¹⁵

Exchange hazards and resulting transaction costs are particularly high if transactions are characterized by a combination of environmental uncertainty and asset specificity or behavioral uncertainty. In this case, (re)negotiations to determine and to adapt exchange conditions will be complicated by the parties' incentives to exploit strategic advantages resulting from dependencies due to specific investments or from problems of performance measurement (behavioral uncertainty). Transaction-specific investments 'isolate' the trading parties from market alternatives and the protection against opportunistic behavior they can provide.¹⁶ Through threats to terminate the relationship, one or both parties may try to renegotiate contract terms and to appropriate a larger portion of the quasi-rent associated with the specialized investment (Williamson, 1985; 1996). Without specific safeguard against such behavior parties may be reluctant to invest in relationship specific assets despite the potential gains from doing so. With asymmetric information about the competence or the performance of a (potential) trading partner or the quality of the products/services he offers, the informed party may disclose information in a selective and distorted way to obtain more favorable contract terms (adverse selection) or to evade contractual obligations (moral hazard).

TCE argues that market governance will generally be the transaction cost efficient governance mode if product quality or individual performance can be measured easily *and* the transaction involves low levels of asset specificity. Transactions that involve products or tasks whose quality is hard to measure and/or substantial investments in specific assets pose greater exchange hazards to transacting parties. More complex contractual arrangements (hybrids) or hierarchical governance will generally be needed to effectively control these hazards.¹⁷ For transactions, for which the hazards related to measurement problems or specific assets are particularly severe, internal (within-firm) organization (hierarchical governance) will tend to be the most efficient

¹⁵ For the different types of transactions costs see Milgrom and Roberts (1992) and Standifird and Marshall (2000).

¹⁶ As abandoning the relationship results in the loss of the value of the specialized assets, specific investments effectively lock transacting parties into a bilateral trading relationship, even if both contract parties have been in competition prior to the investment (Williamson, 1985: 61–63).

¹⁷ For more details on the argument for asset specificity see Williamson (1985; 1996), for behavioral uncertainty see Alchian and Demsetz (1972) for the case of moral hazard) and Barzel (1982) for the case of adverse selection.

form of governance. For intermediate levels of measurement problems and asset specificity hybrid governance may often be the most efficient form of governance. Even for this intermediate case, hybrid forms of governance, will not be optimal, however, if environmental uncertainty is too high (Williamson, 1985: 80; 1996: 116-117). As the degree of uncertainty increases, the transactions costs of hybrid governance increases particularly strongly, and one of the polar extremes, hierarchy or market, will generally become the transaction-cost minimizing governance structure (Williamson 1985: 80). While frequent and highly consequential changes in the economic environment to which the terms of exchange have to be adjusted (high environmental uncertainty) may increase transaction costs under all forms of governance, the hybrid mode is arguably the most affected. Under hybrid governance, adjustments to environmental changes “cannot be made unilaterally (as with market governance) or by fiat (as with hierarchy) but require mutual consent. Consent, however, takes time” (Williamson, 1996: 116).

The comparative efficiency of the alternative modes of governance does not only depend on the characteristics of the transactions but also on the institutional environment. It depends in particular on the quality of formal and informal contracting institutions. While the quality of contract law and of contracting institution more generally affects the transaction costs under all three modes of governance, its effects are arguably the largest for hybrid governance structures (Williamson, 1991; 1996: 115-116). The argument, that parties will choose complex forms of contractual arrangements (hybrids) for intermediate levels of asset specificity or behavioral uncertainty, critically depends on the assumption that sufficiently effective contracting institutions exist to support these arrangements.

Problems associated with weak formal contracting institutions may, however, be alleviated by employing informal relation- or reputation-based institutions of contract enforcement. These informal institutions can attenuate incentives to behave opportunistically and thereby reduce the transaction costs of inter-firm as well as intra-firm exchange. The benefits of well-working *inter-firm* reputation and relation-based enforcement mechanisms are likely to be largest for hybrid governance, which is associated with the greatest hazards of opportunism in *inter-firm* trading (and relies on more complex contracting than the other modes of governance). Hybrid contracting will therefore be more prevalent, in environments where inter-firm reputation mechanisms are

working well, *ceteris paribus* (Williamson, 1996: 116).¹⁸ In environments with particularly weak legal contract enforcement institutions hybrid governance may only be viable in the presence of well-functioning informal (relation or reputation-based) contract enforcement institutions

This last argument suggests that there may be, more generally, a complementary relation between (complex) formal contracts and informal institutions (personal relationships) in the governance of exchange—in particular in institutional environments with weak formal contract enforcement institutions. There are different views in the literature, however, as to whether (and when) the use of one type of institution may generally be expected to rather increase or decrease the functionality of the other (for the following discussion see Zenger et al., 2002; Poppo and Zenger, 2002; Zhou and Poppo, 2007). Many institutional economists acknowledge the importance and widespread use of informal institutions in developed and in particular in less developed economies, but argue that—at least in modern economies—impersonal formal institutions and explicit contracts provide the superior means to avoid the risks inherent in market exchange. Other researchers, particularly in the field of strategic management consider informal institutions and relational governance as more effective and less costly alternatives to formal institutions of governance, however. They argue, that in the presence of relational governance, formal contracts are at best an unnecessary expense and at worst counter-productive (see Poppo and Zenger, 2002; Zenger et al., 2002 for references). According to this view, informal relationships based on social norms that support the emergence of trust and cooperative behavior remove the need for formal governance institutions, such as complex, explicit contracts or vertical integration. They facilitate adaptation and support economic exchanges without the added costs of negotiating and amending detailed formal contracts. And formal institutions may not only be unnecessary, they may even undermine the formation of relational, trust-based governance. According to this view, formal contracts, and explicit incentive schemes and controls may crowd out intrinsic motivation and undermine trust by signaling distrust. Making contracts more explicit may thus encourage rather than discourage opportunistic behavior.

An alternative perspective is that formal institutions, in particular complex inter-organizational contracts, and informal relation-based institutions may generally function as complements in

¹⁸ Similarly, if intra-firm reputation effects improve, within firm opportunism will be reduced and the costs of hierarchical governance will fall (Williamson 1996: 116).

governing exchange. In particular in settings where exchange hazards are severe, the combination of formal and informal institutions may lead to better exchange performance than either institutional type in isolation (see Zenger et al., 2002; Zhou and Poppo, 2007). According to this view appropriately designed formal institutions (contracts) can promote the development and maintenance of informal institutions, and the positive effects of formal institutions in reducing exchange hazards may be increased or even depend on the presence of informal institutions.

By lowering information, monitoring, and enforcement costs formal institutions can make informal constraints possible solutions to more complex exchange problems (North, 1990: 46/7). Customized formal contracts specify contingencies, adaptive processes, controls and penalties to narrow the domain around which parties can be opportunistic. They mitigate opportunistic behavior and thereby support relational governance.¹⁹ Formal institutions (explicit contracts) may also support the development and maintenance of cooperative norms and trust in particularly vulnerable stages of an exchange relationship. They can, in particular, set the stage for the development of cooperative relations in the early stages of a (potentially) long-term interaction. Formal contracts specify expected behavior and the fulfillment of these expectations promotes the generation of cooperative beliefs and trust. And they can help exchange partners to deal with highly consequential unexpected disturbances, which may place considerable strain on an exchange relationship. By providing a customized framework for bilateral adjustments to changing conditions formal contracts may promote the longevity of exchanges and facilitate the evolution of cooperative exchange relations and their adjustment to unexpected disturbances.

Formal institutions and in particular complex contracts (hybrids) alone may also be unable to maintain the continuity of the relationship in case of highly consequential unexpected disturbances, however (Williamson, 1996: 116-7). In such situations formally specified processes

¹⁹ In repeated exchange relationships the pursuit of short-term gains from behaving opportunistically may be deterred by (expected) future losses due to the breakdown of the relationship caused by that opportunistic behavior. In such a setting formal institutions (explicit contracts) may support cooperation by extending the expected duration of the relationship and/or by restricting the gains from short-term opportunistic behavior. Contracts may formally specify a long-term commitment to exchange and specify penalties for early termination of the relationship. Formal institutions may thus be a way to lock parties into relationships with sufficient duration. At the same time, by clearly articulating clauses that specify punishments for opportunistic behavior, well crafted formal contracts may limit the short-term gains that the exchange partners can expect from one-time deviations from cooperative behavior. By decreasing the gains from (potential) opportunistic behavior such contracts increase the comparative gains from cooperating in the exchange relationship and promote expectations that parties will behave cooperatively.

of dispute resolution do not guarantee the continuance of the relationship or a mutually acceptable, bilateral resolution.²⁰ Relational norms fostering flexibility and continuance may be necessary to facilitate adjustments to highly consequential disturbances and to increase the odds of continuing the relationship.

More generally, informal institutions can increase the performance of formal institutions because formal rules and contracts are inherently incomplete to some extent. Due to cognitive limitations of the contracting parties (bounded rationality) and the costs of specifying contract clauses (in an enforceable way), it is generally impossible for contracting parties to foresee and pre-specify all future contingencies in a comprehensive contract. Therefore, formal contracts alone may not provide sufficient protection against hazards of exchange. Informal agreements may be needed to supplement or refine formal contractual arrangements. Where formal contractual terms are too complex or legal contract enforcement institutions too weak informal institutions may also help, or even be necessary, to enforce formal contracts. It may then be excessively costly or even impossible to enforce formal contracts by taking recourse to the legal system alone.²¹ As not only court enforcement but also formal private dispute solution mechanisms are weak in many developing countries, informal institutions will have to play an important role in enforcing formal contracts and solving disputes over contracts in these countries. Where the legal system cannot be expected to effectively interpret and enforce formal contracts, informal institutions and relation-based governance will be necessary to give trading partners some confidence that formal contracts and their intent will be honored. As a consequence, exchange partners may be willing to develop complex explicit contracts only, when informal personal relationships supporting the enforcement of these contracts exist between the partners.

In sum, these arguments suggest that at least in environments where the legal enforceability of contracts is low there is a positive reciprocal (complementary) relationship between relational

²⁰ In particular, the enforcement of formal contracts by courts often implies the end of an ongoing relationship (Dixit, 2004: 25).

²¹ Even in countries with highly developed legal systems using the court system to solve disputes and enforce contracts is far from costless. Generally therefore, if disputes arise, the parties will (first) attempt to solve them by taking recourse to private, formal as well as informal, conflict resolution and enforcement mechanisms. This is even more likely in many developing countries where the legal rules regarding contract resolution that are in place are weak and/or courts cannot be expected to apply the existing rules in an informed, sophisticated, and low-cost way (Dixit, 2004: 83).

governance and formal contracts. Formal contracts promote relational governance and relational governance enables the refinement and the enforcement of formal contracts. This suggests that trading partners in weak institutional environments tend to rely more on personal relations and relational norms as their contracts become increasingly customized, and to employ greater contractual complexity as they strengthen personal relationships and relational governance.

3. Institutional Environment for Doing Business in China

3.1 Legal and Political Environment in China in General

Since the beginning of economic reforms in 1979, China has been undergoing a dramatic transition from a centrally planned economy towards a market economy. Economic reforms have been accompanied by a continuing succession of changes in the legal system. This is true in particular for changes of contract law and, to a lesser extent, of laws related to property right protection, which are both especially relevant for doing business in China.

At the beginning of the reform process, the law focused on supporting the running of the state sector rather than supporting private economic activity. The first Economic Contract Law, which was passed in 1981, was intended largely to regularize relations between State-Owned Enterprises (Clarke et al., 2008: 381). As economic reforms gradually led to a great expansion in the number and importance of local government enterprises and non-state economic agents, which were not core parts of the traditional state system, the role of law shifted towards “providing the rules and processes that govern, however incompletely and imperfectly, the interactions of independent economic agents” (Clarke et al., 2008: 379). Several steps were taken to broaden the overall scope of contract law. Specific contract laws were passed covering exchanges between domestic and foreign firms (Foreign Economic Contract Law, 1985), and technology transfers such as licensing (Technology Contract Law, 1987), and in 1993 the Economic Contract Law was amended to cover almost all *domestic* contracting parties *except individuals*. Finally, in 1999, the different contract laws were replaced by a single new Contract Law, that provided a uniform legal framework for economic contracts by individuals and enterprises alike, regardless of ownership and nationality (Clarke et al., 2008: 392).

Since the beginning of reforms, there has also been some, if more limited, progress in establishing legal institutions to protect property rights. Laws and regulations pertinent to legitimating and protecting (private) property rights include the constitution, company laws, laws regarding intellectual property, and criminal codes about violations of property rights (Li, 2004: 106). China long lacked a systematic statement of the law of property, however. Only in 2007, after several years of considerable controversy and delay, a unified Property Law was passed (Clarke et al., 2008: 393). For the first time since the establishment of the People's Republic of China this law defines and introduces the concept of property rights in a unified way covering state property, collective property as well as private property (for a discussion see OECD, 2008: 23-27). To ensure that the law was passed, a number of areas—including modalities of legal redress—have been left vague, however (OECD, 2008: 23). Thus, although the new law formally opens the way to legal actions by private individuals and companies to protect their rights, the effectiveness of that protection is still unclear in practice.

Despite these legal developments, the Chinese legal system does not provide a secure system of property rights for a number of reasons (see Clarke et al., 2008: 393-395, 399-400, 422). There are a surprisingly large number of bodies that have the right or practical power to enact overlapping laws or regulations of varying degrees of binding effect. And there is no effective system for enforcing jurisdictional or subject matter limitations on any particular body's lawmaking power. The legal system is unable to resolve conflicts between rules enacted by different levels or different arms of government.²² Also, in many cases legislation does not say what is to happen if a particular norm is violated. The possibility of court involvement cannot be generally assumed when a law is violated, and even if the courts became involved, their effectiveness is highly uncertain. Often other government agencies can ignore court decisions with impunity. Thus the courts in China do not have the power necessary to provide secure property rights. There is a clear lack of constraints on government's decision making power and of dispute resolution institutions beyond the control of the political powers whose action they might be asked to overturn.

²² In practice, regulations enacted by lower levels of government often seem to trump theoretically superior regulations promulgated by higher levels of government (Clarke et al., 2008: 393).

A major deficiency of the current Chinese legal system is the lack of a consistent application and effective enforcement of laws and contracts by courts. During the reform period, the role of courts has expanded considerably.²³ Economic change and new legislation have vastly expanded the set of activities over which courts have jurisdiction and there is evidence that businesses are going to court in increasing numbers (Clarke et al., 2008: 393). Courts, however, remain weak and have a low status in the political system. The enforcement of court judgments is a continuing problem. One of the main reasons for the lack of an efficient application and enforcement of laws is the dependence of courts on local government (ibid.: 395).²⁴ This makes it hard for courts to take decision that are against the wishes of local governments, and allows local governments to influence courts (or to ignore their decision) in order to accommodate the interests of companies with strong political relationships.²⁵

Despite continued institutional reform since 1979, the Chinese government has not created the legal structure necessary to impartially and consistently enforce contracts and property rights. Thus, the *legal* protection of business interests in China remains relatively weak. Against this background, the strong investment-driven economic growth in China suggests that there must have been other mechanisms that protected property rights to some reasonable degree and thus allowed economic actors to expect reasonable and predictable return from their investments. It has been argued that the central government's strong and transparent focus on the objective of economic growth has served as the main safeguard against the expropriation of (private) investments.²⁶ And it has been further argued that the credibility of this assurance has been strengthened by delegating economic decision making authority to regional governments and

²³ In the planned economy the legal institutions were not needed to resolve economic disputes. The role of the courts was largely limited to carry out sentencing in criminal matters.

²⁴ The power to appoint and to dismiss a court's leadership rests with (local) governments or Communist Party organizations at the same administrative level. Local governments also control court finances, material supplies, and welfare benefits for court officials (Clarke et al., 2008: 395).

Other reasons for the lack of an efficient application and enforcement of laws are the widespread corruption and the general low level of legal training and competence of judges (Clarke et al., 2008; Trebilcock and Leng, 2006: 1554).

²⁵ For examples, see Li (2004).

²⁶ One may, of course, ask why Chinese leaders focus so strongly on the economic growth objective. One reason (see Trebilcock and Leng, 2006: 1556) may be that the *performance legitimacy* of the Chinese Communist regime depends on its ability to sustain employment expansion and to raise the living standards of the Chinese population by delivering high growth rates. According to this view the Chinese population will not press vigorously for more democratic forms of government as long as the government delivers high levels of economic growth and prosperity. For a discussion of alternative explanations for the Chinese Government's focus on the economic growth objective see Qian and Wu (2008).

providing local officials with an incentive system that gives them an interest to promote regional economic development and not to engage in arbitrary confiscation and expropriation of private property (Clarke et al., 2008: 399-403; Trebilcock and Leng, 2006: 1554-1557; Keefer, 2006). This interest is argued to stem from two noteworthy elements of the Chinese political system: the *fiscal federalism system* and the *cadre evaluation system* (Clarke et al., 2008; Trebilcock and Leng, 2006; Qian, 2003; Keefer, 2006). Under the Chinese system of fiscal federalism the regional governments' expenditures were closely linked to the (tax) revenues they generated (Qian, 2003).²⁷ This gives local officials incentives to attract and to support productive local businesses, e.g., by providing security to property rights, as they directly benefit from higher tax revenues and fees. These incentives have been further strengthened by the cadre evaluation system (Clarke et al., 2008; Trebilcock and Leng, 2006; Keefer, 2006). This system sets criteria for evaluating the performance of leading Party and government officials, which is an important factor in determining the officials' remuneration and advancement prospects. The most heavily weighted performance criteria emphasize promoting economic growth, collecting tax revenues and generating employment opportunities. These objectives cannot easily be achieved without providing a considerable degree of security to property rights of local businesses.

While the fiscal system and the cadre evaluation system may have contributed to aligning local officials' interests with the central party's and government's economic growth objectives and may also have reduced the risk of expropriation of investments of private (and local public) enterprises, the effects have always been limited by local officials' corruption and favoritism. And the effectiveness of the fiscal system and the cadre evaluations system in affecting local officials' interests and behavior has decreased over the reform period (Clarke et al., 2008; Keefer, 2006). The continuing growth of the private sector with its lucrative career opportunities has led to a relative decline of the importance of the cadre evaluation system and an increase in the relative benefits to cadres of pursuing privately beneficial actions, including corruption and favoritism, even at the expense of the central party's growth interest" (Keefer, 2006: 211). Personal relationships to local cadres may still provide security for private investors, however (Keefer, 2006: 212).

²⁷ This is true in particular for the fiscal contracting system that was in place until 1993. This system featured very high (often 100%) marginal revenue retention rates (Qian, 2003: 316). In 1994 the fiscal contracting system was replaced by a tax-sharing system that substantially reduced revenue retention rates (Clarke et al., 2009: 401).

3.2 Informal Institutions in China: the Role of Personal Relationships

Personal relationships and informal networks are generally considered to play a particularly important role in the governance of business transaction in China (Li, 2004: 107, Standifird and Marshall, 2000: 22). While the cultivation of long-term personal relationships in some form and to some extent exists in every society, its specific form (*guanxi*) and its pervasiveness and importance in daily social and business life are often considered distinctively Chinese (Standifird and Marshall, 2000: 22). The pervasive use of *guanxi*-based exchange in business activities of all sorts is an important element of the (economic) institutional environment in China (Li 2004: 107; Standifird and Marshall, 2000: 29).²⁸

In their specific Chinese form personal relationships (*guanxi*) are cultivated through the repeated exchange of gifts and favors, which creates a sense of reciprocal obligation and indebtedness of the partners (Standifird and Marshall, 2000: 22-23). By developing personal (*guanxi*-based) relationships to several other persons that may also develop personal relationships among each other the development of individual (bilateral) relationships ultimately leads to a network of relationships (the *guanxi* network).²⁹ A failure to follow the rules of reciprocity and equity in a *guanxi*-based relationship results in loss of face and the identification as being untrustworthy. This in turn results in the degradation and possible dissolution of the *guanxi*. As the loss of face associated with opportunistic behavior with one exchange partner spreads through the whole network it can easily result in the offending party's banishment from the network altogether.

²⁸ There are two basic arguments on why the Chinese rely on *guanxi* (see Li 2004: 107-8): The cultural approach argues that the influence of the traditional Chinese culture is the fundamental reason for the use of *guanxi* in the Chinese society. According to this view, the Chinese cultural heritage over thousands of years has favored social relations as a means to coordinate economic exchanges. The institutional approach argues that the predominant reliance on personal relationships in China is due to the weakness of formal contracting and property rights institutions, which implies that people have to rely on personal relationship to protect their transactions and property rights. (The two arguments are not mutually exclusive. Actually, the two factors—cultural tradition and the deficiency of formal institutions—may mutually reinforce each other in defining the role of personal relationships in China; Li 2004: 108; also see Section 2.1 above). While scholars of the cultural approach tend to think that the role of *guanxi* will remain essential in China, scholars of the institutional approach predict a decline of *guanxi*-based business relationships as China's legal system and formal market institutions improve (Li 2004: 108, on the latter see also Section 2.1).

²⁹ While *guanxi* can develop between two persons without any commonality of shared identifications, such commonalities may serve as a catalyst in the development of a *guanxi* relation without predetermining it (see Langenberg 2007: 59-62 and the literature cited there). Possible sources of these commonalities, so-called "guanxi bases", may be kinship, fictive kinship (common surnames), locality or dialect, work place (colleagues or classmates or army comrades) or business associations or social clubs (Luo, 2007: 4-6).

Thus, the cost of opportunistic behavior is the potential loss of exchange opportunities with all members of the network.

Within *guanxi* networks, the threat of network expulsion provides an increased assurance that one's exchange partner will not act opportunistically. Network membership may also reduce the costs of assessing the competence and reliability of potential network partners.³⁰ These advantages do not come for free, however. Establishing and cultivating personal relationships takes time and other resources. Moreover, having to choose, due to reciprocal obligations, transaction partners from within one's personal network may foreclose the choice of the most efficient trading partner and may inhibit potentially profitable transactions with people outside the network (cf. Section 2.1).³¹

Beyond personal relationships with private business partners, personal relationships with government and party officials are also frequently considered highly significant for doing business in China (see, e.g., Langenberg, 2007).³² In current China, local and central governments dispose of ample means of affecting the terms and the success of private business decisions. Business operations require licenses, permits and approvals from various governmental authorities and are subject to numerous business laws and regulations. The requirements for obtaining licenses and permits as well as the terms and interpretation of business regulations often lack transparency. They can differ substantially across provinces, districts and even towns and are subject to frequent changes. Governments may also affect business success via their influence on the allocation of land-use rights³³ and of other scarce resources, via their decisions on subsidies, favorable tax treatments and government procurement contracts, and via their influence on court decisions and their enforcement (cf. Section 3.1).

Against the background of public officials' numerous instruments and wide discretionary powers to intervene with business operations, businessmen may have a strong interest in extending their

³⁰ Generally, therefore, the risk of opportunistic behavior will be lower the larger the size and the scope of the *guanxi* network (Standifird and Marshall, 2000).

³¹ According to (Langenberg, 2007: 77 fn 96) "it is regarded as improper indeed unthinkable to resort to an outsider if a network member is capable of assisting".

³² Actually, relationships with government officials and Communist Party executives "are often considered the 'real' *guanxi*" (Langenberg: 2007, 141).

³³ In China, real property belongs to the state, from which individuals and corporate entities purchase land-use rights, usually for a period of fifty years (Langenberg 2007: 143).

networks of personal relationships to public officials. Personal relationships with public officials may be important for a wide variety of business related activities. They can help to obtain mandatory licenses or permits, to get early access to information about upcoming changes in government policies or other business-related information, to obtain land-use rights and to securing access to scarce resources (and to finance), or to obtain favorable tax treatment or subsidies (Langenberg 2007: 141-5; Standifird and Marshall, 2000: 31, 35). More generally, personal relationships with public officials can help to smoothen business operations and to reduce the risk of expropriation caused by weak legal protection.³⁴

There are two basic arguments on why the Chinese rely on *guanxi* (see Li 2004: 107-8): The cultural approach argues that the influence of the traditional Chinese culture is the fundamental reason for the use of *guanxi* in the Chinese society. According to this view, the Chinese cultural heritage over thousands of years has favored social relations as a means to coordinate economic exchanges. The institutional approach argues that the predominant reliance on personal relationships in China is due to the weakness of formal contracting and property rights institutions, which implies that people have to rely on personal relationship to protect their transactions and property rights.³⁵ While scholars of the cultural approach tend to think that the role of *guanxi* will remain essential in China, scholars of the institutional approach predict a decline of *guanxi*-based business relationships as China's legal system and formal market institutions improve

3.3 Institutional Environment for Doing Business in the GPRD

It has been argued in Section 3.1 that, despite continued institutional reform since 1979, the enforcement of contracts and the legal protection of business interests are still weak in China, in general. It has also been argued that local and regional governments can have a substantial influence on business success in general and on court decisions and on the quality of law enforcement, in particular. As a consequence, the quality of the (legal) protection of business

³⁴ Personal relation with officials may not only help to get support for one's own business but also help to obstruct potential competitors, however (cf. Section 2.1., see Li, 2004 for examples).

³⁵ The two arguments are not mutually exclusive. Actually, the two factors—cultural tradition and the deficiency of formal institutions—may mutually reinforce each other in defining the role of personal relationships in China (Li 2004: 108; also see Section 2.1 above).

interests (property rights protection) and of contract enforcement can differ substantially across Chinese provinces and even across districts and municipalities within provinces.

As this study focuses on Hong Kong (HK) companies operating in the Pearl River Delta (PRD) in the province Guangdong, the quality of the institutional environment of Guangdong province (as well as that of HK) is of particular interest here. Guangdong has been a pioneer region of the Chinese economic reforms over the last three decades. At the beginning of the so-called “open door policy”, three special economic zones in Guangdong (and one in the province of Fujian) have been opened for foreign direct investments in 1980. Ever since, the business and investment environment in Guangdong has been more developed and more business friendly than in many other Chinese provinces. In its “Report on Doing Business in China 2008” (World Bank, 2008a), the World Bank compared the business and investment environments of the 30 major cities in China, including the capital city of each province (with the exception of Tibet) and four centrally administered municipalities. Four indicators of a business-friendly environment were compared: the ease of starting a business, registering property, getting credit and enforcing contracts. Guangzhou, the capital city in Guangdong, ranked at least among the top three cities for all four indicators. With respect to contract enforcement Guangzhou even ranked as the best city in China. As there may be substantial variation in the quality of the institutional environment in general and of contract enforcement in particular between different cities of the same province this finding need not be generalizable to all municipalities within Guangdong province. Still, it seems reasonable to suspect that contracting institutions (and property rights institutions) may be more developed in Guangdong than in most other Chinese provinces.

As the current study investigates the business operations of HK companies operating in the PRD in Guangdong, it is not only the institutional environment in Guangdong but also that in HK that could be expected to matter for business decisions of the companies surveyed. HK is generally considered one of the freest market economies in the world. It exhibits very high rankings in most governance indicators. According to World Bank (2008b), HK ranked (in 2008) in the top 10% percentile of countries for “Regulatory Quality” (percentile rank 100), “Government Effectiveness” (95.3), “Control of Corruption” (94.2) and “Rule of Law” (90.9)., The quality of the institutional environment in HK may thus be considered overall very favorable for business,

although HK ranked somewhat lower in “Political Stability” (86.1) and in “Voice and Accountability” (60.6).³⁶ Against such background, HK companies may regard the institutional environment in Guangdong as strongly deficient (and certainly much less favorable than that in HK itself), even though it may be more developed and business friendly than that in most other provinces in mainland China.

In an environment with deficient formal (contracting and property rights) institutions companies may be expected to make increased use of informal institutions and personal relationships (networks) to govern business transactions (cf. Section 2). Establishing and cultivating new personal relationships takes time and money and may be particularly difficult for managers or owners of companies who are foreigners and are not acquainted with such practices, however. Although the owners and leading executives of our focus companies may not be “mainland Chinese”, informal business practices should be much more familiar to them than to managers from western countries. There are historically strong ethnic, cultural, and language linkages between HK and Guangdong (Canton). About 95% of the HK residents are Cantonese-speaking and a majority of HK citizens are either born or are descended from counties or villages in Guangdong. About 80% of HK’s Chinese population have relatives in Guangdong (Child and Möllering, 2003: 73-74; Nicholas and Maitland, 2007: 117-118). These strong cultural and kinship ties are expected to make it easier for business owners and executives from HK to develop personal relationships and networks and to employ relation-based institutions for doing business in the PRD. The geographic proximity of Hong Kong and Guangdong may be expected to further facilitate establishing and employing personal relationships as it makes frequent contacts with and direct monitoring of business partners in Guangdong relatively inexpensive for HK managers (Nicholas and Maitland, 2007: 118).³⁷

³⁶ China, for comparison, ranked in 2008 in the 25th-50th percentile for “Rule of Law” (percentile rank 45.0), “Control of Corruption” (41.1), “Regulatory Quality” (46.4) and “Political Stability” (33.5), somewhat higher in “Government Effectiveness” (63.5) and substantially lower in “Voice and Accountability” (5.8) (World Bank; 2008b).

³⁷ These advantages may be reflected in the high share of foreign direct investment in Guangdong originating from HK companies. According to Guangdong provincial statistics more than 70% of all FDI agreements signed between 1979 and 2006 are with HK companies (Chen and Unterberdoerster 2008: 3). In 1985 almost ninety percent of FDI in Guangdong was invested by HK entrepreneurs; in 2006 still almost half of all FDI in Guangdong came from HK (Shari and Huang 2008: 6).

4 Survey Background and Data Representativeness

This study investigates the role of personal relationships for doing business in China by analyzing an original firm-level dataset collected from a survey among HK electronics SMEs operating in the PRD in China.³⁸ Our focus on *HK*-based companies with business operations in the *PRD* offers several advantages for our research. Managers from HK companies operating in PRD can be expected to be familiar with both, well developed (Western-type) institutions (as in HK) and the peculiarities of Chinese formal and informal institutions. Due to the strong social and cultural ties that exist between HK and Guangdong (and their geographic proximity) managers from HK firms can, in particular, be expected to find it easier than Western managers to develop and cultivate personal relationships with Chinese managers or government officials, if they wish to do so (see Section 3.3). Also, the fact that the PRD has been a pioneer region for economics reforms in China and the supposition that formal contracting institutions and property rights institutions are generally more developed in Guangdong than in most other Chinese provinces, but are at the same time still highly deficient compared to those in HK (see Section 3.3), should be helpful to distinguish between cultural and institutional motives for using personal relationships.

The focus on the PRD can also be justified by the size of its economy and its substantial importance as a relatively low-cost production location for sustaining HK companies' market competitiveness. In terms of GDP, Guangdong has the largest economy of all Chinese provinces. About 80% of the GDP in Guangdong was created in its core region, the PRD, in 2006. The relocation of business activities of HK companies has contributed substantially to the economic development in the PRD (Enright et al., 2005). By far the largest share of FDI in Guangdong originates from HK, and HK companies' FDI in China has focused strongly on the PRD, and Guangdong province more generally (FHKI, 2003; Shari and Huang 2008).

In order to limit firm and industry heterogeneity, the study focuses on SMEs from one particular industry, the electronics industry.³⁹ The electronics industry is the most important manufacturing

³⁸ We focus on the HK SMEs instead of large companies because of their prevalence (98%) among all the companies registered in HK (HKSCC, 2008)

³⁹ The electronics industry consists of the manufacture of “special-purpose machinery”, “electrical machinery and equipments”, “communication equipments, computers and other electronic equipments” and “instruments, meters and machinery for cultural and office use”. It produces goods ranging from low-tech household appliances and accessories to high-tech digital equipments (NBSC, 2007, GB/T4754-2002).

industry in the PRD and has been one of the most important industries for the HK economy (e.g. Tuan and Ng, 1995; FHKI, 2007). It is a very dynamic industry with a high intensity of global competition. Electronics products and the related production activities are generally characterized by short product life-cycles, quick product-related process modifications, and a high dependency on research and development expenditures for industry advancement (Tuan and Ng, 1995). In combination with the high intensity of global competition these features force companies to continuously optimize the organization of their production and innovation processes.

We obtained basic information on the HK electronics SMEs from the company data bank of the HK Trade Development Council (TDC)⁴⁰, in which 4,572 HK companies were registered as electronics SMEs with operations in the PRD in Sept. 2007. Our local cooperation partner, the Social Science Research Centre (SSRC) at the University of Hong Kong, sent interview invitations to senior executives of 3,000 companies randomly selected from the TDC data bank. Senior executives in 104 companies agreed to give personal interviews to complete the questionnaires.⁴¹ We were aware that only a small fraction of senior executives would be willing to spend the time (approx. 60 minutes) necessary to participate in this survey. We considered personal interviews with senior executives necessary, however, to obtain reliable high quality information about the actual decision makers' assessment of the importance of personal relationships for doing business in PRD, China.

In total, 104 questionnaires were completed by interviewing executives from 104 companies. Executives from all 104 interviewed companies were asked to indicate the number of their employees in HK at the end of 2006 (see Appendix, Q17). However, to comply with the public definition of the SMEs in HK, we excluded two companies with more than 100 employees in HK from our sample.⁴² Table 4.1 presents the share of companies by firm size in HK for our sample and for the whole population, respectively. The chi-square test finds no significant difference between the distributions of firm size of our sample and of the whole population. This suggests

⁴⁰ The TDC is an industrial association with a strong linkage to the HK government. It offers a wide range of services to facilitate the creation of opportunities in international trade for the HK-based companies, especially HK SMEs. URL: <http://www.hktdc.com/>.

⁴¹ In addition, the SSRC carried out follow-up work to clarify potential misunderstandings in executives' responses.

⁴² For more information on HK's definition of SMEs, see HKCSD (2007).

that our sample is representative for the whole population of HK electronics SMEs operating in the PRD with respect to the firm size in HK.

Table 4.1: Firm size distribution for our sample and for the firm population of the TDC data bank (company shares in %)

Firm size (Number of employees in HK)	≤ 5	6-10	11-15	16-25	26-50	51-100	Total
Our sample	52.0	27.5	5.9	7.9	3.9	2.9	100 (n=102)
Population from TDC data bank	44.1	28.3	8.7	9.2	6.8	2.9	100 (N=4452) ^a

Note: ^a In total, 120 companies are excluded from the 4572 companies. 91 companies have more than 100 employees in HK and 29 companies did not give information on their size.

Source: Own HK Survey 2007 and TDC data bank

5 Survey Results

5.1 General importance of Personal Relationships

In the questionnaire there were several questions relating to the general importance of personal relationships for companies' business operations. In one of these questions, executives were directly asked to assess the relative importance of personal relationships for doing business in HK and in the PRD for their company (see Appendix, Q1). As shown in Table 5.1, more than 68% of the 102 respondents indicated that making use of personal relationships for business is more important for their company in the PRD than in HK.

Table 5.1 – Importance of personal networks for doing business in the PRD relative to importance in HK (company share in %)

Much more important	Somewhat more important	As important as	Somewhat less important	Much less important	Total
48.0	20.6	23.5	3.9	3.9	100 (n=102)

Source: Own HK Survey 2007

Given the fact that formal legal and market institutions are certainly more developed in HK than in the PRD (see Section 3.3), this dominant opinion of a higher importance of using personal relationships for business operations in the PRD than in HK may be considered as support for the institutional view on the role of personal relationships. But, considering HK's long British colonial history and its influence on current HK (business) culture, the result is certainly also compatible with the cultural view of the role of personal relationships.

The reasons why HK companies in the PRD make use of personal relationships for doing business in the PRD were addressed more directly in another question (see Appendix, Q2). In total, six potential reasons for using personal relationships or networks were specified in the

survey questionnaire: to follow the “culture-determined pervasive way of doing business in PRD” (CultureDet), “to substitute for missing governmental laws and regulations” (SubGovLaw), “to substitute for missing formal business rules and procedures” (SubBusRule), “to reduce risks and uncertainties while doing business” (RiskUncert), “to respond quickly to customer demands” (RespCust), and “to increase company’s operational flexibility” (ComFlex). Executives were asked to assess the importance of these factors as reasons for *their company’s* use of personal relationships for doing business in the PRD using a five-level importance scale (Likert scale). Table 5.2 reports the corresponding responses, showing that about 60% of the respondents consider increasing operational flexibility (ComFlex) and the ability to respond quickly to customer needs (RespCust) as very important or important reasons, while only about 40% do so for reducing risks (RiskUncert). The shares of respondents that consider the other three reasons, namely to follow a culture-determined tradition (CultureDet) or to substitute for missing laws or formal business rules (SubGovLaw; SubBusRule) as very important or important take intermediate values of about 50 to 55%.

Table 5.2 – Importance of reasons for using personal relationships for doing business (company share in %)

	1. very important	2. important	3. of normal importance	4. of little importance	5. not important	Total
CultureDet	27.5	24.5	28.4	7.8	11.8	100 (n=102)
SubGovLaw	25.5	30.4	20.6	7.8	15.7	100 (n=102)
SubBusRule	17.7	30.4	24.5	13.7	13.7	100 (n=102)
RiskUncert	15.7	23.5	43.1	6.9	10.8	100 (n=102)
RespCust	23.5	36.3	26.5	6.9	6.9	100 (n=102)
ComFlex	21.6	41.2	23.5	5.9	7.8	100 (n=102)

Source: Own HK Survey 2007

Overall, the differences in declared importance between the different reasons are generally fairly moderate. Pair-wise two-tailed Wilcoxon Signed Rank Tests (WSRTs) between all pairs of reasons find few significant differences in the importance of the individual reasons. Only the reasons “reducing risks and uncertainties” and “substituting for missing formal business rules and procedures” are found to be significantly less important than “responding quickly to customer needs” and “increasing operational flexibility”.⁴³

⁴³ The numerical results of these WSRTs (and of WSRTs referred to in the following discussion) are not documented here. They are available from the authors upon request.

For interpretative purposes the six reasons can be classified into three groups. The first group (Group1) consists of the first two reasons: substituting for missing governmental laws and regulations (SubGovLaw) and substituting for missing formal business rules and procedures (SubBusRule). These reasons are clearly linked to the institutional view that personal relationships are of particular importance in business environments characterized by deficient formal (legal and market) institutions. The second group (Group2) consists of just one reason, namely to follow the culture-determined pervasive way of doing business in China (CultureDet). It is linked to the cultural view of personal relationships in an obvious way. The third group of reasons (Group3) consists of the remaining three reasons: reducing risks and uncertainties (RiskUncert), responding quickly to customer needs (RespCust), and increasing companies' operational flexibility (ComFlex). For this third group of reasons it is more difficult to relate their (declared) importance to the institutional or cultural view of personal relationships. They are essentially performance objectives, and we do know little as to why firms, which indicate these objectives to be (very) important motives for their companies' use of personal relationships, think that they can achieve these objectives by using personal relationships. In particular, we do not know whether they expect personal relationships to be further advantageous for achieving these objectives even if formal institutions were well developed.^{44 45}

Overall the answers summarized in Table 5.2 suggest that companies using personal relationships for doing business in the PRD have multiple reasons for doing so. For a majority of companies Chinese culture is an important reason. Simply following Chinese culture and traditions is not the only important reason for doing so, however. Deficient legal institutions and public regulations are also playing an important role for many companies. Increasing operational flexibility and the ability to respond quickly to customer demands are important objectives that companies (of the

⁴⁴ This corresponds to the view that cultivating personal relationships may be a superior form of governance as compared to formal rule-based governance, in which case formal contracts may be unnecessary or even counter-productive (cf. Section 2.2).

⁴⁵ 2-tailed Spearman-rho correlation tests indicate that the assessments of importance of the different reasons are generally significantly positively correlated. Among all pairs of reasons, the correlation coefficients between the reasons "substituting for missing governmental laws and regulations" and "substituting for missing formal business rules and procedures" as well as those between the reasons "reducing risks and uncertainties", "responding quickly to customer needs" and "increasing operational flexibility" are particularly high. This may be considered an additional justification for our grouping of the different reasons. (The pair-wise correlation coefficients and the corresponding test results are not documented here. They are available from the authors upon request.)

highly dynamic and competitive electronics industry) are trying to achieve by using personal relationships.

Given the fact that public officials in China still have ample opportunities to directly or indirectly intervene in companies' operations (see Section 3) companies may not only consider personal relationships with private economic agents important for doing business in the PRD but also personal relationships with public officials. Based on this supposition, executives were asked to assess the general importance of personal relationships with public officials for different business "activities" in the PRD (see Appendix, Q3). Ten different activities were specified in the questionnaire: getting "permissions for investment/production" (PInv), and "permissions for sales in China" (PSales), getting or improving "access to buildings and/or land" (Build), "access to workers" (Labour), "access to scarce materials and resources" (Resour), "access to governmental support" (GovSup), and "access to business information" (BInfo), "importing machines or materials" (Import), "expanding company scale" (Expan), and "solving business disputes" (SolDis).

The distribution of responses assessing the importance of personal relationships with public officials for the different business activities is summarized in Table 5.3.

Table 5.3 – Importance of personal relationships with public officials for different business activities (company share in %)

	1. very important	2. important	3. of normal importance	4. of little importance	5. not important	Total
PInv	23.5	33.3	21.6	5.9	15.7	100 (n=102)
PSales	18.0	32.0	19.0	6.0	25.0	100 (n=100)
Build	24.0	28.0	17.0	5.0	26.0	100 (n=100)
Labour	13.7	9.8	26.5	18.6	31.4	100 (n=102)
Resour	11.9	19.8	18.8	16.8	32.7	100 (n=101)
Import	16.7	24.5	19.6	10.8	28.4	100 (n=102)
Expan	11.8	22.6	28.4	14.7	22.6	100 (n=102)
GovSup	12.9	10.9	24.8	11.9	39.6	100 (n=101)
BInfo	15.7	20.6	21.6	18.6	23.5	100 (n=102)
SolDis	26.5	25.5	22.6	7.8	17.7	100 (n=102)

Source: Own HK Survey 2007

For each of the ten activities, a considerable share of executives considers personal relationships with public officials important or even very important. This share is particularly large (at or above 50%) for getting permissions for investment or production (PInv) and for sales in China (PSales) as well as for getting access to real estate (Build). This suggests that personal relationships with public officials are helpful or even necessary for companies to get access to

“resources” that are crucial for companies’ operations and are, to some extent, still under the control of government.⁴⁶ Relationships with public officials are also considered to be of particular importance for solving business disputes (SolDis).

This result may be interpreted as an indication for the continuing weakness of courts and formal private dispute settlement institutions in the PRD. This interpretation receives some additional support from an analysis of Spearman-rho correlations between the importance of personal relationships with public officials for different business activities (see Table 5.3) and the importance of different reasons for applying personal relationships for business in general (see Table 5.2). The correlation coefficients are presented in Table 5.4. The correlations between the assessment of the importance for the “institutional reasons” of Group1 (SubGovLaw and SubBusRule) and the assessment of personal relationships with government officials are statistically (highly) significantly positive for most of the activities specified. This gives some support for the supposition that personal relationships with public officials are advantageous for coping with the deficiencies of the institutional environment in the PRD.⁴⁷ Again, the results for the cultural reason for using personal relationships (CultureDet) are not much different from that of the “institutional reasons”, however. Thus, also with respect to companies’ assessment of personal relationships with government officials both cultural and institutional reasons seem to play an important role.

Table 5.4 – Spearman-Rho correlations between “importance of relationships with public officials for business activities” and “importance of reasons for using personal relationships for business”

n=100	SubGovLaw	SubBusRule	RespCust	ComFlex	RiskUncert	CultureDet
PIInv	0.204**	0.409***	0.116	0.149	0.169*	0.379***
PSales	0.167*	0.222**	0.114	0.123	0.056	0.253**
Build	0.149	0.267***	0.033	0.120	0.054	0.159
Labour	0.204**	0.307***	0.112	0.124	0.059	0.154
Resour	0.125	0.214**	0.017	0.131	0.104	0.235**
Import	0.279***	0.326***	0.065	0.145	-0.013	0.171*
Expan	0.078	0.261***	0.086	0.199**	0.100	0.247**
GovSup	0.044	0.117	-0.017	0.027	-0.037	0.097
BInfo	0.197**	0.312**	0.123	0.201**	0.166*	0.272***
SolDis	0.362***	0.323***	0.120	0.260***	0.156	0.305***

Note: *** 1%, ** 5%, * 10% significance level in 2-tailed tests

Source: Own HK Survey 2007

⁴⁶ Public officials’ interests in a growing regional economy do not seem to be sufficient to guarantee an efficient and non-discriminatory access to these resources (cf. Section 3.1).

⁴⁷ This is true in particular for solving business disputes (SolDis).

Results so far suggest that companies using personal relationships for doing business in the PRD do so for different reasons. Both cultural reasons as well as institutional reasons are considered to be important by large share of executives interviewed. As cultural reasons for using personal relationships may be expected to be more persistent than institutional reasons (see Sections 2.1 and 3.3), this implies that even if the formal institutional environment in PRD continues to improve, culture-determined traditions may still encourage companies to perceive personal relationships as important for their business operations in the PRD.

Indeed, executives' responses to a survey question (see Appendix, Q4), which directly asked them to indicate whether they agree to the statements that “personal relationships will become less important for doing business in PRD “if the institutional framework there is getting better and market mechanisms are getting more efficient” are strongly divided (see Table 5.5). The share of the 102 executives that agrees to that statement (40.3%) is almost equal to the share that disagrees (39.3%).⁴⁸

Table 5.5 – Agreement on reducing importance of personal relationships in the PRD over time (company share in %)

Totally agree	Agree	Neutral	Disagree	Totally disagree	Total
12.8	27.5	20.6	26.5	12.8	100 (n=102)

Source: Own HK Survey 2007

5.2 Importance of Personal Relationships in Location and Partner Choice

The results of the previous section suggest that a large share of HK-based electronics SMEs operating in the PRD consider personal relationships as important for doing business in the PRD, in general. This section deals with the importance of personal relationships, relative to other decision criteria, for two specific types of strategic business decisions (location choice and partner choice) for companies' production and innovation activities.⁴⁹

⁴⁸ 2-tailed Spearman-rho correlation tests indicate that executives that consider personal relationships with public officials more important also tend to agree less with the expectation that personal relationships will become less important with further institutional progress.

⁴⁹ Remember that restrictions on partner (and location) choices are often considered to be an important disadvantage of relation-based governance of business operations (see Section 2.1 and 3.2).

Location choice

In the survey, there were in total three questions regarding the determinants of companies' location decisions. First, executives were asked to assess the importance of different criteria for their own company's decisions to perform or keep certain business functions in HK (see Appendix, Q7). Second, they were asked to assess the importance of different decision criteria for their company's choice of its main production location within the PRD (see Appendix, Q6). And third, executives of the subset of companies that perform innovation activities in the PRD were asked to assess the importance of different criteria for their company's choice of its main innovation location in the PRD (see Appendix, Q14).

Regarding the decision to perform certain business operations in HK, the following location criteria were specified in the questionnaire: "the availability of qualified labor and new technology" (HQLabNtech), "access to superior business services" (HBusSer), "proximity to other companies in the same or related sectors" (HProximity), "few governmental restrictions/interventions" (HFewGov), "well-established legal system" (HLegalSys), "well-developed markets" (HDevMkt), "personal and/or family ties" (HPersRL), and a "positive location image" (HLocImg). Table 5.6(a) reports the distribution of the importance that executives attributed to the different criteria. The results show, that almost all executives consider HK's well-established legal system (HLegalSys) as a very important (about 73%) or important (an additional 22%) criterion for keeping some business operations in HK. In contrast, only about 31% of executives consider existing personal and family ties (HPersRL) as an important or very important criterion for that decision. This is by far the smallest share of all eight decision criteria proposed. This assessment is in line with most executives' assessment that personal relations are generally (much) less important in HK as compared to the PRD (see Table 5.1). The overall ranking of the importance of the different location criteria may be taken as an indication that HK's well-developed legal system is its most important source of comparative advantage over the PRD. Other particularly important factors are the good access to superior business services (HBusSer) and the comparatively few governmental restrictions and interventions (HFewGov).⁵⁰

⁵⁰ Pair-wise 2-tailed WSRTs allow to classify the eight different criteria into 5 groups of importance: "HLegalSys" is the most important one, followed by "HBusSer" and "HFewGov" as the second group, followed by "HDevMkt"

Table 5.6 – Importance of locational criteria for operating in HK (5.6a), for production in the PRD (5.6b), and for innovation in the PRD (5.6c) (company share in %)

	1. very important	2. important	3. of normal importance	4. of little importance	5. not important	Total
Table 5.6a – criteria considered for still operating in HK						
HQlabNtech	24.5	34.3	14.7	6.9	19.6	100 (n=102)
HBusSer	50.0	37.3	9.8	1.0	2.0	100 (n=102)
HProximity	11.8	30.4	28.4	14.7	14.7	100 (n=102)
HFewGov	52.0	32.4	7.8	2.9	4.9	100 (n=102)
HLegalSys	72.6	21.6	2.0	1.0	2.9	100 (n=102)
HDevMkt	42.2	31.4	13.7	3.9	8.8	100 (n=102)
HPersRL	14.7	16.7	12.8	14.7	41.2	100 (n=102)
HLocImg	32.4	42.2	13.7	3.9	7.8	100 (n=102)
Table 5.6b – criteria considered for deciding production location in the PRD						
PCheapPF	37.6	24.7	17.2	6.5	14.0	100 (n=93)
PInfrastr	37.6	38.7	14.0	5.4	4.3	100 (n=93)
PProximity	31.2	28.0	15.1	4.3	21.5	100 (n=93)
PTaxExmp	11.8	22.6	23.7	16.1	25.8	100 (n=93)
PFewGov	18.3	22.6	29.0	9.7	20.4	100 (n=93)
PLegalSys	16.1	18.3	26.9	17.2	21.5	100 (n=93)
PPersRL	8.6	17.2	14.0	16.1	44.1	100 (n=93)
Table 5.6c – criteria considered for deciding innovation location in the PRD						
IQuaLab	24.3	28.6	25.7	11.4	10.0	100 (n=70)
IInnoStr	7.1	20.0	24.3	20.0	28.6	100 (n=70)
IProximity	11.4	31.4	28.6	8.6	20.0	100 (n=70)
ITaxExmp	7.1	11.4	20.0	27.1	34.3	100 (n=70)
IFewGov	14.3	18.6	30.0	20.0	17.1	100 (n=70)
ILegalSys	14.3	10.0	25.7	27.1	22.9	100 (n=70)
IPersRL	2.9	5.7	22.9	15.7	52.9	100 (n=70)

Source: Own HK Survey 2007

We also calculated Spearman-rho correlations between the importance of different location criteria (HLegSys, HDevMkt, HPersRL) for keeping operations in HK and the reasons for using personal relationships for doing business in the PRD in general (from Table 5.2). Table 5.7a displays the results. They show that executives which more strongly emphasize the importance of HK's well-established legal system (HLegSys) and well developed markets (HDevMkt) as reasons for keeping operations in HK also tend to regard the ability to respond quickly to customer demands (RespCust) and to increase the company's operational flexibility (ComFlex) as particular important motives for using personal relationships in the PRD.

and "HLocImg" as the third group, followed by "HQlabNtech" and "HProximity" as the fourth group, and followed by "HPersRL" as the least important criterion.

Table 5.7 – Spearman Rho Correlations between “importance of reasons for using personal relationships for business” and “importance of selected locational criteria” for operation in HK (5.7a) and for location choice for production and innovation within PRD (5.7b)

	SubGovLaw	SubBusRule	RespCust	ComFlex	RiskUncert	CultureDet
Table 5.7a – selected locational criteria in case of keeping operations in HK (n=102)						
HLegSys	0.169*	0.062	0.266***	0.334***	0.161	0.212**
HDevMkt	0.108	0.119	0.313***	0.345***	0.243**	0.104
HPersRL	0.155	0.123	-0.126	-0.036	0.088	0.027
Table 5.7b – selected locational criteria in case of production location (n=93) and innovation location (n=70)						
PPersRL	0.006	-0.014	0.154	0.243**	0.096	0.063
IPersRL	0.169	0.364***	0.075	0.087	0.232*	0.192

Note: *** 1%, ** 5%, * 10% significance level in 2-tailed tests

Source: Own HK Survey 2007

According to the executives surveyed, existing personal relations were of little importance for their companies’ decision to keep some of their operation in HK. Given the overall greater importance of personal relationships for doing business in the PRD one might still expect that the existence of personal relationships is a more important factor in companies’ decisions between alternative production (or innovation) locations within PRD. As discussed in Section 2.1 and 3.2, it is often considered as one of the main disadvantages of relation-based systems of governance that—by restricting the choice of business partners to pre-existing networks—it may foreclose the choice of the most efficient locations for doing business. In order to investigate whether there may be a real danger of inefficient location decisions due to restricted personal networks in the specific case of HK-based SMEs investing in the PRD, we asked executives to assess the importance of a number of pre-specified criteria for their companies’ choice between different production and innovation locations within the PRD. For the choice of production location the following seven criteria were specified: “cheap production factors” (PCheapPF), “transportation and communication infrastructure” (PInfrac), “proximity to other companies in the same or related sectors” (PProximity), “tax exemptions or preferential treatments from the local government” (PTaxExmp), “few governmental regulations on production” (PFewGov), “well-established legal systems” (PLegalSys) and “personal or family ties” (PPersRL). The set of criteria for the choice of innovation locations differs from that for production locations with respect to only three criteria, which are reformulated to become more innovation specific: the supply of cheap production factors is replaced by the supply of “qualified labor and/or researchers” (IQuaLab), transportation and communication infrastructure in general is replaced by “innovation structure such as universities, science parks, and venture capital companies”

(IInnoStr) and few governmental regulations on production is replaced by “few governmental regulations or rules on innovation activities” (IFewGov). The other four criteria for innovation location stay the same as those for production location: “proximity to other companies in the same or related sectors” (IProximity), “tax exemptions or preferential treatments from the local government” (ITaxExmp), “well-established legal systems” (ILegalSys) and “personal and/or family ties” (IPersRL).

Table 5.6b and 5.6c summarize the responses on the importance of the different criteria for companies’ choices of production and innovation locations within the PRD, respectively. Regarding the choice of production locations, valid responses were obtained for 93 companies.⁵¹ More than 75% of the 93 respondents consider the availability of good transportation and communication infrastructure (PInfrast) as an important or even very important criterion for their companies’ choice of production locations. For cheap production factors (PCheapPF) and the proximity to other companies in the same or related sectors (PRximity) the corresponding numbers are about 62% and 59%, respectively. In contrast, only about 26% of them assess personal relationships on site as important or very important. Almost half of the respondents (44.1%) consider personal relationships on site as “not important”. Pair-wise 2-tailed WSRTs confirm that the existence of personal relationships is considered the least important of all of the specified location criteria for production. This result need not be viewed as being in conflict with the general importance of personal relationships for doing business in PRD. Companies may just be able to develop new personal relationships (if they consider such relationships to be important); they may be able to do so, in particular in locations with proximity to other companies in the same or related sectors.

For the choice of innovation locations, personal relationships turn out to be even less important than for the choice of production locations. Out of the 70 executives from companies that actually carried out innovation activities in the PRD⁵² less than 9% consider the existence of personal or family ties as a very important or important criterion for their companies’ choice of their

⁵¹ There were only 93 companies answering the corresponding question, because 9 out of the 102 companies surveyed neither owned a production plant in PRD nor did they have cooperative arrangements with a production plant in the PRD. They organized production in the PRD exclusively by placing orders to (independent) suppliers.

⁵² Only the executives from the 70 companies in the sample that actually carried out innovation activities in the PRD were asked to respond to the question on the criteria for the choice of innovation locations within the PRD.

innovation locations (see Table 5.6c). More than 50% of them even take this criterion as not important at all. In contrast, the availability of qualified labor and researchers (IQuaLab) is assessed by the largest share of respondents (53%) as very important or important. As for production, the proximity to other companies in the same or related sectors (IProximity) is also considered important or even very important by a comparatively high share of respondents. Pair-wise 2-tailed WSRTs confirm that the existence of personal relationships is the least important among the specified criteria for companies' choice of their innovation locations.

Overall, this suggests that, despite the general importance of personal relationships for business in the PRD as found in the Section 5.1, personal relationships are of minor importance to companies' locational decisions. This holds true for the decision to keep operation in HK as well as for the choice among different potential production and innovation location within the PRD. Personal relationships do not seem to bar most companies from basing their location decision on hard location factors. In principle there are two possible (general) explanations for this; First, the companies' ability to build on existing or establishing new personal relationships may differ little between different locations within the PRD; or at least those that guarantee close proximity to other companies in the same or related sectors. Second, other factors may simply have an even greater influence on firm performance than personal relationships.

Still, there are some companies that consider personal relationships important or very important for selecting their production or innovation locations. In order to get some ideas about the underlying reasons for these assessments, we calculate the Spearman-rho correlations between the importance of "personal and family ties" as a location criterion and the importance of the different reasons for using personal relationships for business in the PRD in general (from Table 5.2). We do so for the decision to keep operation in HK (HPersRL) as well as for the choice of production and the innovation location within the PRD (PPersRL, IPersRL). Table 5.7 reports the results. No significant correlations can be found between the importance of personal relationships for keeping some operations in HK and the six reasons why companies use personal relationships for doing business in the PRD. This should be expected as one variable relates to the role of personal relationships in HK (where it is of minor importance, anyway), while the other variables relate to the role of personal relationships in the PRD. For the choice of production location, companies that attach higher importance (than other companies) to personal relationships as a determinant of location choice also tend to attach a particularly high importance to increasing

their operational flexibility as a reason for applying personal relationships. In contrast, companies that attribute higher importance to personal relations as a factor in the choice of innovation location tend to consider substituting for missing formal business rules (SubBusRule) and the reduction of business risks and uncertainties (RiskUncert) as (even) more important reasons for using personal relationships (than other companies). Given the characteristics of electronics industry as described in Section 4 and the institutional environment in the PRD (Section 3.3), this seems to be broadly in line with expectations. In order to be competitive in the highly dynamic electronics industry the flexibility of production is of utmost importance. Personal relationships may help increase that kind of flexibility no matter how good formal institutions are. Most HK electronics SMEs are likely to have rather little experience with organizing innovation processes and particularly with organizing them in the PRD. Risks and uncertainties associated with innovation are higher than those with production activities and formal business rules and procedures related to innovation are likely to be even less developed than those related to production in PRD. Companies organizing innovation activities in the PRD seem to consider personal relationships an important instrument for dealing with these problems.

Partner choice

Even though personal relationships are of only minor importance for companies' location choices, we may still expect them to be of some importance for the choice of production or innovation partners. In the questionnaire executives were therefore asked to assess the importance of seven pre-specified criteria for their companies' choice of production partners and innovation partners in the PRD (see Appendix, Q12 and Q16). These questions were addressed only to executives from the companies cooperating with other economic agents for production (46 companies) or innovation (51 companies) in the PRD, respectively. The same seven criteria were specified for both cases; "required by Chinese laws or regulations" (PCNLaw; ICNLaw)⁵³, "expertise of the partners" (PExpertise; IExpertise), "good experiences in former business" (PBusiExp; IBusiExp), "good reputation of the partners" (PReputation; IReputation), "existence of personal relationships with potential partners" (PPersRP; IPersRP), help to "get along with

⁵³ "P" refers to the case of selecting production partners, while "I" refers to the case of selecting innovation partners.

local workers or suppliers well” (PLocalWS; ILocalWS) and help to “get along with public officials well” (PPubOfficial; IPubOfficial).

We tend to think of the last three of these criteria as relating either directly ((PPersRP/IPersRP) or indirectly (PLocalWS/ILocalWS; PPubOfficial/IPubOfficial) to personal relationships. That is, we interpret a potential partner’s ability to help to “get along with public officials” as his ability to develop or cultivate personal relationships with public officials (similarly for workers or suppliers in case of PLocalWS/ILocalWS).⁵⁴ The second to fourth criteria (PExpertise/ IExpertise; PBusiExp/IBusiExp and PReputation/IReputation), in contrast, do not related to personal relationships, in our view. They rather refer to more “objective” qualities of the potential partners.

Table 5.8a summarizes the executives’ assessments of the importance of the different criteria for their companies’ choice of production partners. Only for a small fraction of companies (10.9%) legal or regulatory requirements play an important or very important role in the choice of production partners. For almost three-quarters of companies they are not important at all. We can thus assume that most companies were not restricted by law in their partner choice and were thus able to choose their preferred partners. Each of the three quality criteria (expertise (74%), good business experiences (76.1%) and good reputation (73.9%)) is assessed to be important or very important for production partner choice by about three-quarters of responding executives. For “existence of personal relationships” the corresponding share is substantially lower. But it is still a majority of executives (54.4%) that considers (direct) personal relationships as important or even very important for their companies’ choice of production partners. For the other two (indirectly relationship-related) criteria “to get along with local workers and suppliers well” and “to get along with public officials well” the corresponding ratios are only about 24% and 13%, respectively.⁵⁵

⁵⁴ For PPubOfficial/IPubOfficial, the role of personal relationships is more indirect (by referring to the potential partner’s personal relationships to third parties and at the same time more specific (by referring e.g., to the relationships with public officials only) than for the (more direct and general) criterion PPersRP/IPersRP.

⁵⁵ Pair-wise 2-tailed WSRTs confirm the “obvious” ranking of importance of the different criteria. PExpertise, PBusiExp, and PReputation are significantly more important than PPersRP, which in turn is more important than PLocalWS and PPubOfficial. PCNLaw is the least important criterion.

Table 5.8 – Importance of criteria for choice of production partners (5.8a) and innovation partners (5.8b) (company share in %)

	1. very important	2. important	3. of normal importance	4. of little importance	5. not important	Total
Table 5.8a – criteria considered for deciding production partners in the PRD						
PCNLaw	2.2	8.7	6.5	8.7	73.9	100 (n=46)
PExpertise	45.7	28.3	15.2	6.5	4.4	100 (n=46)
PBusiExp	39.1	37.0	15.2	0.0	8.7	100 (n=46)
PReputation	39.1	34.8	17.4	2.2	6.5	100 (n=46)
PPersRP	17.4	37.0	28.3	8.7	8.7	100 (n=46)
PLocalWS	8.7	15.2	30.4	17.4	28.3	100 (n=46)
PPubOfficial	6.5	6.5	19.6	13.0	54.4	100 (n=46)
Table 5.8b – criteria considered for deciding innovation partners in the PRD						
ICNLaw	3.9	2.0	15.7	11.8	66.7	100 (n=51)
IExpertise	37.3	29.4	21.6	7.8	3.9	100 (n=51)
IBusiExp	35.3	31.4	25.5	5.9	2.0	100 (n=51)
IReputation	31.4	41.2	19.6	3.9	3.9	100 (n=51)
IPersRP	3.9	25.5	29.4	15.7	25.5	100 (n=51)
ILocalWS	3.9	23.5	29.4	11.8	31.4	100 (n=51)
IPubOfficial	3.9	11.8	21.6	13.7	49.0	100 (n=51)

Source: Own HK Survey 2007

Overall, the results suggest that the “objective” criteria to evaluate the qualities of potential partners play a dominant role in most companies’ choice of production partners. Still personal relationships play an important role in the choice of production partners for a majority of companies.

A 2-tailed WSRT of the importance of “PPersRP” (from 5.8a) against the importance of “PPersRL” (from 5.6b) indicates that personal relationships are of significantly higher importance for companies’ partner decisions as compared to their location decisions in the case of production. This conforms to the expectations expressed at the top of this subsection.

As regards the importance of the different criteria for partner choice for innovation, the empirical results (Table 5.8b) are mostly similar to the case of production. Legal and regulatory requirements are of minor importance. The more “objective” quality criteria such as partners’ expertise, good business experiences, and good reputation (IExpertise, IBusiExp, and IReputation) are assessed to be important or very important for a large majority of companies in their choice of innovations partners. They are significantly more important than the other specified criteria. Compared to the case for production partners, personal relationships (IPersRP) are much less important for companies’ choice of innovation partners. And contrary to the case of production, in the choice of innovation partners direct personal relationships are not more

important than the partners' ability to "to get along with local workers and suppliers well" (ILocalWS).

The lower importance of personal relations in partner choice for innovation as compared to production may be explained by the greater importance of specific knowledge and skills for innovation activities and by the greater scarcity of these skills. As a consequence, relying on personal relationships, rather than expertise and other objective criteria, in the choice of cooperation partners is more costly for innovation as compared to production. Still as in the case of production, a 2-tailed WSRT of the importance of "IPersRP" against the importance of "IPersRL" in 5.6c suggests that personal relationships are significantly more important for the choice of innovation partners than for the choice of innovation locations.

Overall, however, there is no evidence that the importance of (existing) personal relationships for doing business in PRD may lead HK-based companies to neglect "objective" criteria when deciding about either innovation or production partners. Personal relationships tend to be significantly less important than the other criteria for companies' partner choices.

Still there are some companies that consider personal relationships important or very important for selecting their production or innovation partners. In order to get additional insights into the underlying reasons for these assessments we calculated Spearman-rho correlations between the importance of the three criteria related to personal relationships in partner choice (both for production and for innovation) and the importance of the reasons for applying personal relationships for business in the PRD in general (see Table 5.2). Table 5.9 reports the results.

For the choice of production partners (Table 5.9a), the importance of personal relationships in general is significantly and positively correlated with three of the six reasons behind companies' decisions to use personal relationships for business in the PRD in general. These relate to the two important performance objectives of operational flexibility and responsiveness to customers (in this last case there is also a positive correlation with PLocalWS), and to cultural determinants. Those companies that consider personal relationships as important criteria in their choice of production partners seem to follow quite distinct motives. While some try to use personal relationships to increase their flexibility and responsiveness, others seem to just follow cultural norms. For the choice of innovation partners (Table 5.9b), there is just one statistically significant positive correlation, namely between the importance of potential partners' ability to get along

with local workers and suppliers (ILocalWS) as a determinant of partner choice and the importance of substituting personal relationships for missing formal business rules and procedures (SubBusRule) as a general reason for using personal relationships. A similar result has been observed for the importance of personal relations in the case of the choice of innovation location (see Table 5.7). These findings seem to support the view that there are different motives for companies to use personal relationships for production and innovation. More concretely, for *production* companies that rely on personal relationships to search for and work with partners, do so mainly to increase their operational flexibility and their ability to response quickly to customer needs. In contrast, in case of *innovation* it is rather the large uncertainties and the risk of potentially large losses due to opportunistic behavior of innovation partners, exacerbated by the absence of appropriate formal business rules and procedures for organizing innovation cooperations, that induce—at least some⁵⁶—companies to rely on personal relationships to search for and work with their innovation partners.

Table 5.9 – Spearman Rho Correlations between “importance of reasons for using personal relationships for business” and “importance of selected criteria” for selecting production partners (5.9a) and for selecting innovation partners (5.9b)

	SubGovLaw	SubBusRule	RespCust	ComFlex	RiskUncert	CultureDet
Table 5.9a – selected criteria for partner decisions in case of production partner (n=46)						
PPersRP	0.196	0.125	0.366**	0.349**	0.205	0.326**
PLocalWS	0.043	0.219	0.326**	0.227	0.170	0.223
PPubOfficial	0.023	0.150	0.074	0.075	-0.058	0.153
Table 5.9b – selected criteria for partner decisions in case of innovation partner (n=51)						
IPersRP	-0.042	0.136	0.092	0.097	0.004	0.128
ILocalWS	0.030	0.320**	0.020	0.120	0.086	0.101
IPubOfficial	0.085	0.198	-0.104	-0.102	-0.011	-0.019

Note: *** 1%, ** 5%, * 10% significance level in 2-tailed tests.

Source: Own HK Survey 2007

There are no significant correlations in Table 5.9 between the importance of the potential partners’ ability to help the companies to benefit from their personal relationships with government officials (PPubOfficial, IPubOfficial) and the importance of any of the general reasons for using personal relationships. Anyway, insights into why some companies intend to work with partners that dispose of personal relationships with public officials could rather be

⁵⁶ Remember that it was only a minority of executives that attributed a high or very high importance to personal relationships in their companies’ choice of innovation locations or innovation partners.

expected from analyzing the correlations between the importance of “PPubOfficial” and “IPubOfficial” and the importance of personal relationships with public officials for different business activities that has been summarized in Table 5.3. Table 5.10 reports the corresponding Spearman rho correlations. The most striking result in Table 5.10 is the strong correlation between the importance of both “PPubOfficial” and “IPubOfficial” and “getting access to business-related information” (BInfo)—and possibly also the weaker, but still significant correlations with getting “access to scarce materials and resources” (Resour). In addition, Table 5.10 also finds some significantly positive correlations in case of production but not in case of innovation, or vice versa. We know from Table 5.3, that a large number of executives considered personal relationships with public officials not important at all for getting access to workers (Labour) and getting access to governmental support (GovSup). In these cases the differences in (significance) of correlation for production and innovation in Table 5.10 may simply reflect the fact that access to workers is much less important for innovation than for production, while getting access to government support, e.g. in the form of subsidies, is less of an issue for production. Moreover, with increasing GDP per capita in China more and more low-cost products which were mainly exported to global markets are now also affordable to domestic customers. To increase their sales revenue, companies now need to turn their focus from pure exporting to also selling their products to domestic markets. To change their target markets, companies need to apply for domestic sales permission, which may be easier to obtain if their partner has good personal relationships with public officials.

Table 5.10 – Spearman Rho Correlations between “importance of relationships with public officials for business activities” and “PPubOfficial in the case of production” and “IPubOfficial in the case of innovation”

	PInv	PSales	Build	Labour	Resour
PPubOfficial (n=44)	0.167	0.309**	0.077	0.285*	0.254*
IPubOfficial (n=50)	0.089	0.037	-0.002	0.129	0.274*
	Import	Expan	GovSup	BInfo	SolDis
PPubOfficial (n=44)	0.223	0.241	0.226	0.307**	0.164
IPubOfficial (n=50)	0.173	0.207	0.278*	0.381***	0.110

Note: *** 1%, ** 5%, * 10% significance level in 2-tailed tests.

Source: Own HK Survey 2007

5.3 Formal Governance Structures and Personal Relationships

The discussion in Section 2 suggests that, in the case of weak legal environments, there may be a complementary relation between the complexity of formal contracts and personal relationships in

the governance of production- or innovation-related business transactions. More specifically the discussion suggests that personal relationships should be of greater importance for hybrid governance structures (contract- or ownership-based business cooperations) than for simple market transaction or vertically integrated production. We may thus expect that companies that decided to organize their production and innovation activities by complex inter-firm agreements tend to consider personal relationships more important than other companies. Also, companies that do not rely on personal relations may be expected to avoid using hybrid forms of governance.

In order to clarify the relationships between the importance of personal relationships and the use of hybrid governance structures for organizing companies' production and innovation activities, executives of companies were asked to assess the importance of different governance structures for their companies to organize production and innovation activities (see Appendix, Q8 and Q15), respectively. Regarding production the following four governance structures were specified in the questionnaire: 100% own production (POwn), equity-based cooperative production (PEquCo), contract or agreement-based cooperation (PAgreeCo) and placing production orders to independent suppliers (POrder). Table 5.11a summarizes the responses regarding the importance of the four different governance structures for production. It shows that for more than half of the responding companies placing production orders to suppliers (53%) and/or own production (52%) are very important or important governance structures in organizing production. In contrast, equity-based cooperative production and agreement-based cooperative production are very important or important governance structures for only for 17.6% and 21.6% of companies, respectively. A large majority of companies has never engaged in such cooperative forms of production (about 76.5% and 65.7%, respectively).⁵⁷ This suggests that HK SMEs tend to avoid cooperative (hybrid) governance structures, and to prefer either market or hierarchical forms of governance, for organizing production in the PRD. The large risks of opportunistic behavior and high transaction costs of hybrid governance structures in an environment characterized by high dynamic in technological and market conditions (environmental uncertainty) and weak legal and formal market institutions (see Section 2.2) may, at least, be part of the explanation of this behavior.

⁵⁷ Pair-wise 2-tailed WSRTs confirm that cooperative forms of production are of statistically significantly lower importance than the other two alternatives. No significant difference in importance is found between the two cooperative forms of production.

Regarding governance structures for companies' innovation activities a somewhat different set of governance structures was specified in the questionnaire: own R&D and innovation (IOwn), cooperation with (external) partners (ICoop), acquisition of licenses and/or innovations (IAcqui) and reverse engineering (IReverse).⁵⁸ The responses as to the importance of the different governance structures for innovation are summarized in Table 5.11b. About 48.6% (47.1%) of the 70 “innovating” companies consider own production (reverse engineering) as a very important or important governance structure for innovation. For a slightly smaller share of companies (41.4%) cooperative innovation are very important or important. In contrast, for only 28.6% of companies acquisitions are very important or important for innovation. In contrast to the case of production activities, only a minority of 27.1% of companies never engage in cooperative innovation at all. Pair-wise 2-tailed WSRTs indicate that there is no significant difference in the importance of cooperative innovation on the one hand and that of own innovation and reverse engineering on the other. In contrast, innovation by acquisition is found to be significantly less important than the other three governance modes. Due to high uncertainty and (asset) specificity, acquiring innovations via simple market transactions may often be associated with high transaction costs. At the same time, the lack of technological capabilities and innovation experience of many electronics SMEs, as well as limited resources, may increase (relative to the case of production) companies' willingness to cooperate with some more experienced partners in innovation.

Table 5.11 – Importance of governance structures for production (5.11a) and innovation (5.11b) (company share in %)

	1. very important	2. important	3. of normal importance	4. of little importance	5. not important	6. never applied	Total
Table 5.11a – governance structures for production activities							
POwn	39.2	12.8	6.9	1.0	2.0	38.2	100 (n=102)
PEquCo	9.8	7.8	4.9	1.0	0	76.5	100 (n=102)
PAgreeCo	15.7	5.9	8.8	2.9	1.0	65.7	100 (n=102)
POrder	26.5	26.5	17.7	2.9	3.9	22.6	100 (n=102)
Table 5.11b – governance structures for innovation activities							
IOwn	24.3	24.3	30.0	10.0	2.9	8.6	100 (n=70)
ICoop	15.7	25.7	27.1	4.3	0.0	27.1	100 (n=70)
IAcqui	5.7	22.9	21.4	0.0	2.9	47.1	100 (n=70)
IReverse	17.1	30.0	15.7	12.9	0.0	24.3	100 (n=70)

Source: Own HK Survey 2007

⁵⁸ Note that only executives from companies which carry out innovation activities (n=70) were asked to answer the corresponding question.

For the case of production activities, companies were also asked to provide information about the complexity or comprehensiveness of contracts with their *most important* producer/supplier in the PRD (see Appendix, Q11). More specifically, they were asked to indicate which of the following terms were negotiated and specified in the production or supply agreements with their most important producer: a description of products, the quantity of products, the price of products, delivery times, an exclusivity agreement, and penalties for breach of contracts. The number of different terms that are covered in an agreement is taken as an indicator for the complexity or comprehensiveness of the contract. Acting in an environment with a deficient legal system, one might expect companies to either abstain from writing complex contracts or to rely on personal relationships in enforcing these contracts.

Table 5.12 summarizes the executives' responses on the complexity (number of terms specified) of the production agreements with their *most important* producer/supplier. In total, about 40% of the 102 companies have production agreements with their most important producer/supplier, but a majority of almost 60% of companies does not have such an agreement ("NF" in Table 5.12). The (average) complexity of these contracts depends on the chosen governance structure. If the most important producer is totally owned by the companies (sub-sample a), only about 15.3 % of production agreements include all six specified terms.⁵⁹ In contrast, if companies and their most important producer have an equity-based cooperation (sub-sample b), or an agreement-based cooperation (sub-sample c), about 54.6%, or 65%, of the companies have an agreement that specifies all six terms.

If they do specify an agreement, then companies specify an average of 4 terms when they fully own the producer, 4.4 terms in case of an equity-based cooperation, and as much as 5.3 terms on average in case of an agreement-based cooperation.⁶⁰ Together, these findings suggest that most companies are reluctant to organize the relation with their most important producer/supplier in the form of an equity-based or contract-based cooperation.⁶¹ Companies that do enter such a

⁵⁹ In sub-sample a, 23.6% of the 55 companies (i.e., 13 companies) do have a production agreement and 3.6% of these 55 companies (15.3% of the 13 companies) have specified all 6 terms.

⁶⁰ The mean value of 4 (for the case of full ownership) is found to be significantly smaller than the mean value of 5.3 (for agreement-based cooperation), based on the corresponding t-test result. The other differences, (4 vs. 4.4 and 4.4 vs. 5.3) are not statistically significant, however.

⁶¹ This is in line with the earlier findings on the importance of the different governance structures for organizing production in the PRD, in general (see Table 5.11).

cooperation, however, tend to conclude quite complex, or comprehensive, production agreements with their cooperation partner. This is true for equity-based cooperation, and even more so for contract-based cooperation, where ownership-based control rights are absent.

Table 5.12 – Company distribution by complexity of (number of points specified in) the production agreements signed with companies’ most important producer/supplier in the PRD (company share in %)

PComplexA	NF	0	1	2	3	4	5	6	Total
Whole sample	59.8	2.0	0.0	2.9	2.9	8.8	4.9	18.6	100 (n=102)
Sub-sample a	76.4	1.8	0.0	1.8	3.6	5.5	7.3	3.6	100 (n=55)
Sub-sample b	35.3	5.9	0.0	11.8	0.0	11.8	0.0	35.3	100 (n=17)
Sub-sample c	0.0	0.0	0.0	0.0	5.9	23.5	5.9	64.7	100 (n=17)

Note: Sub-samples a, b, and c cover the cases, in which the governance structures between companies and their most important producer/supplier are own production/full ownership (a), equity-based cooperation (b), and agreement-based cooperation (c), respectively.

Source: Own HK Survey 2007.

Against the background of a still deficient legal contract enforcement system in the PRD (at least compared to HK), personal relationships may be expected to play some role in enforcing these contracts. More specifically, as argued in Sections 2, under weak formal contract enforcement, there may be a complementary relationship between the importance of personal relationships on the one hand and the use of cooperative (hybrid) governance structures and of complex formal contracts on the other hand. To see whether there is evidence for such a relationship in our survey results, we calculated pair-wise Spearman-rho correlations between the importance of personal relationships for the choice of production partners, and of innovation partners, (from Table 5.8) on the one hand and the importance of cooperative (hybrid) governance structures and the complexity of contracts for production (from Tables 5.11(a) and 5.12), and of cooperative governance for innovation (from Tables 5.11 (b)), on the other hand. Table 5.13 reports the results.

Table 5.13 – Spearman-rho correlations between “importance of hybrid governance structures (complexity of production agreements)” and “importance of personal relationships as criterion for partner decisions (production and innovation)”

	PEquCo ^b	PAgreeCo ^b	PComplexA				ICoop ^c
			Whole sample ^a	Sub-sample a ^a	Sub-sample b ^a	Sub-sample c ^a	
PPersRP	0.249*	-0.069	-0.071	-0.500	-0.770***	0.215	
IPersRP							0.143

Note: ^aWhole sample and sub-samples a, b and c are defined as in Table 5.12. The sample and subsamples are further restricted, however, by considering only companies that provided valid answers regarding “PPersRP”. The sub-samples are also restricted to companies that do have framework agreements with their most important producer/supplier. There are, therefore, in total 46, 3, 11 and 17 valid responses in the whole sample, and sub-samples a, b and c, respectively. ^b46 valid responses. ^c51 valid responses.

*** 1%, ** 5%, * 10% significance level in 2-tailed tests.

Source: Own HK Survey 2007.

The correlations are statistically significantly different from zero only for the case of equity-based cooperation for production. Due to small samples (in case of the complexity of agreements versus personal relationships in partner choice there are only 11 observations) even these correlations should be interpreted with great caution, only. Having said this, the results suggest that companies that consider equity-based cooperations more important for organizing their production in the PRD also consider personal relationships more important in their choice of cooperation partners. And for those companies that do have an equity-based cooperation with their most important producer, production agreements (if concluded at all) tend to be more complex for companies that consider personal relationships more important in the choice of their cooperation partners.⁶²

Additional evidence on the relation between personal relationships and formal governance structures may be gained from analyzing the interrelations between the executives' assessments of the importance of different governance structures (cooperative governance structure and the complexity of production agreements) on the one hand and the importance of different reasons for using personal relationships for business in general (from Table 5.2) and the importance of personal relationships with public officials (from Table 5.3) on the other hand. Table 5.14 reports the corresponding Spearman-rho correlation coefficients. There are several noteworthy results: Table 5.14(a) shows that there are several statistically significant positive correlations between the importance of cooperative governance structures for production and innovation, on the one hand and the importance of some of the different reasons of using personal relationships for business on the other hand. Companies that attach higher importance to contract or agreement-based cooperation for production, tend to also consider increasing the “performance goals” (Group3 reasons, see Section 5.1)—namely, increasing responsiveness to customer needs (RespCust), increasing companies' operational flexibility (ComFlex) and reducing risks and uncertainties (RiskUncert)—more important as reasons for using personal relationships for business in general. The same is true for companies that attach higher importance to equity-based cooperation (in case of RiskUncert) and for the complexity of contracts in equity-based cooperation (in case of RespCust and ComFlex). For cooperative governance structures in

⁶² Remember, that the importance scale is defined in such a way that lower numbers stand for higher levels of importance (a value of 1 stands for meaning “very important”, a value of 5 stand for “not important”).

innovation the situation is quite different. Here, companies that attach high importance to cooperative agreements tend to stress the importance of institutional deficiencies—substituting personal relationships for missing governmental laws and regulations (SubGovLaw) and missing formal business rules and procedures (SubBusRule)—and/or cultural traditions (CultureDet) as reasons for using personal relationships. Overall this seems to suggest, companies applying (or stressing the importance of) hybrid governance structures for production tend to use personal relationships mainly to reduce business risks and to increase their customer responsiveness and flexibility. In contrast, companies applying hybrid governance structures for organizing innovation activities use personal relationships mainly to cope with weak legal institutions and deficient regulatory policies and missing formal business rules and procedures in the field of innovation (or simply to follow cultural traditions). They may use personal relationships, for example, to increase the binding effect of contracts and to reduce the hazards related to business agreements with private innovation partners, or to assure preferential access to government programs or subsidies in the field of innovation promotion and to avoid the expropriation of innovation outcomes by government.

This last argument suggests that these companies, i.e. companies with hybrid governance structures in innovation, may also be expected to more strongly emphasize the importance of personal relationships with public officials for a number of different business activities.⁶³ This supposition is supported by the results reported in column (7) of Table 5.14b. There are several significant and positive correlations between the importance of cooperation in innovation and the importance of personal relationships with public officials for different business activities, most of which are of potentially high importance for companies' innovation policies.

For production, in contrast, there is generally no significant correlation between the assigned importance of hybrid governance structures (or complexity of the production agreements) and the importance of personal relationships with public officials (see columns (1)-(6) in Table 5.14b). This is well in line with the generally weak correlations between the importance of these

⁶³ This expectation is reinforced by our finding in Sections 5.1 (Table 5.4) that the executives' assessment of the importance of institutional and cultural reasons for using personal relationships is significantly positively correlated with the importance executives' attribute to personal relationships with public officials for a number of different business activities.

governance structures and the importance of institutional and cultural reasons for using personal relationships for business in PRD in general (as documented in Table 5.14a, columns (1)-(6)).

Table 5.14 – Spearman-rho correlations between “importance of hybrid governance structures (complexity of production agreements)” and “importance of reasons for applying personal relationships for business (5.14a)” and “importance of personal relationships with public officials for business activities (5.14b)”

	PEquCo ^b	PAgreeCo ^b	PComplexA			ICoop ^c	
			Whole sample ^a	Sub-sample a ^a	Sub-sample b ^a		Sub-sample c ^a
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Table 5.14a							
CultureDet	0.119	0.109	-0.173*	-0.015	-0.199	0.167	0.265**
SubGovLaw	0.095	-0.047	-0.056	0.233	-0.318	-0.050	0.237**
SubBusRule	0.142	0.139	-0.185*	0.114	-0.497	0.068	0.231*
RespCust	0.097	0.245**	-0.234**	0.191	-0.598*	0.078	0.147
ComFlex	0.056	0.235**	-0.196**	0.047	-0.650**	0.290	0.192
RiskUncert	0.239**	0.210**	-0.239**	-0.310	-0.331	0.311	0.164
Table 5.14b							
PInv	0.017	0.070	-0.081	0.058	-0.266	-0.105	0.167
PSales	-0.008	-0.053	0.071	-0.125	-0.653**	-0.095	0.064
Build	-0.101	0.105	0.004	-0.019	-0.220	0.011	0.179
Labour	0.081	0.233**	-0.131	-0.111	-0.281	-0.214	0.428***
Resour	-0.045	0.129	-0.103	-0.226	-0.219	-0.002	0.246**
Import	-0.029	0.127	-0.048	0.083	-0.426	0.051	0.237*
Expan	-0.024	0.169*	-0.057	-0.180	-0.480	-0.119	0.221*
GovSup	-0.108	0.025	0.036	-0.186	-0.643**	-0.131	0.240**
BInfo	-0.013	0.100	-0.131	-0.054	-0.390	-0.166	0.274**
SolDis	0.062	0.113	-0.074	-0.153	-0.304	0.193	0.252**

Note: ^aWhole sample and sub-samples a, b and c are defined as in Table 5.12, with the additional restriction that the sub-samples contain only those companies that do have framework agreements with their most important producer/supplier. For the whole sample, by contrast, companies without framework agreement, NF, are included as 0 terms specified. There are in total 102, 13, 11 and 17 (100, 13, 11, 17) valid responses in the whole sample, and sub-samples a, b and c in Table 5.14a (Table 5.14b), respectively. ^b102 (100) valid responses in Table 5.14 (a) (Table 5.14b). ^c70 (69) valid responses in Table 5.14a (Table 5.14b). Note: *** 1%, ** 5%, * 10% significance level in 2-tailed tests.

Source: Own HK Survey 2007.

6 Conclusions

This paper has investigated the role of personal relationships for doing business in the GPRD, China. Despite continued institutional reform since 1979, the enforcement of contracts and the legal protection of property rights are still weak in China, in general. While the PRD has been a pioneer region for economics reforms in China, and formal contracting and property rights institutions are generally more developed there than in most other Chinese regions, they are still clearly deficient compared to those in HK.

Institutional economics suggests that in an institutional environment with deficient formal (contracting and property rights) institutions companies should be expected to make increased use of informal institutions and personal relationships (personal networks) to govern business transactions. There are thus institutional-economic reasons in addition to the often stressed cultural reason for business companies to make extensive use of personal relationships both with private business partners and with public officials, in China.

As to the relation between personal relationships and companies' formal governance structures, institutional economics is less clear. There are reasons, however, to expect that in environments with particularly weak legal contract and property rights enforcement, formal institutions and informal, relation-based institutions may generally function as complementary to each other in governing exchange. In particular, in such an environment hybrid governance structures, such as equity- or contract-based cooperations and complex inter-firm contracts, may only be viable in the presence of well-functioning informal (relation-based) contract enforcement.

The potential advantages of personal relationships in governing exchange do not come for free, however. Restrictions on partner (and location) choices, in particular, are often considered to be an important disadvantage of relation-based governance of business operations. Having to choose, due to reciprocal obligations, transaction partners from within one's personal network may foreclose the choice of the most efficient trading partners or the most efficient locations and may inhibit potentially profitable transactions with people outside the network.

In this paper we used firm-level data obtained from a survey among executives of HK-based electronics SMEs operating in the PRD to shed some new light on the empirical validity of these suppositions. The results confirm the importance of personal relationships for doing business in the PRD, in general. More specifically they also confirm the importance of personal relationships with public officials. The results suggest that companies using personal relationships for business operations in the PRD do so for several different reasons. For a majority of companies Chinese culture is an important reason for using personal relationships. It is not the only important reason for doing so, however. Deficient legal institutions and public regulations are also playing an important role for many companies. Increasing operational flexibility and the ability to respond quickly to customer demands are important objectives that companies, from the highly dynamic and competitive electronics industry, are trying to achieve by using personal relationships.

Personal relationships with public officials are considered (very) important for a number of business activities; particularly so for getting permissions for investment and getting access to real estate, as well as for solving business disputes.

While executives attach high importance to personal relationships for business in the PRD in general, they are of only secondary importance for companies' location and partner choices both for production and, in particular, for innovation activities. Executives consider other more "objective" criteria more important in their companies' location and partner choices. Overall, there is no evidence that the importance of (existing) personal relationships may lead HK-based companies to neglect "objective" criteria when deciding about either innovation or production partners (or locations). Still personal relationships play an important or even very important role in the choice of production partners (innovation partners) for a majority (about thirty percent) of companies. The reasons why some companies consider personal relationships as (very) important for partner choice tend to differ between production and innovation. For production companies tend to employ personal relationships to increase their operational flexibility and to respond quickly to customer needs, while for innovation they tend to employ personal relationships to cope with deficient legal institutions or missing formal business rules and procedures.

There is some evidence for a complementary relation between the importance of personal relationships on the one hand, and the importance of cooperative governance structures and the complexity of business agreements on the other hand. As for partner choice, the reasons why companies consider personal relationships important when they choose hybrid governance structures tend to differ between production and innovation activities. Again, companies choosing hybrid governance structures for organizing their production tend to emphasise increasing their operational flexibility and their ability to respond quickly to customer needs, as well as the reduction of risks and uncertainties, as important reasons for using personal relationships, while companies choosing hybrid governance structures for organizing innovation tend to emphasize the deficiencies in legal and formal market institution as well as cultural factors as important reasons for using personal relationships. These latter companies also tend to attach a higher importance to personal relationships with public officials.

Maybe not surprisingly given the different—institutional as well as cultural—motives for using personal relationships, executives differ sharply in their views on the *future* role of personal

relationships for doing business in the PRD. The share of executives that (strongly) agrees with the proposition, that “personal relationships will become less important for doing business in PRD if the institutional framework there is getting better and market mechanisms are getting more efficient” in the future, is almost equal to the share that (strongly) disagrees with that proposition. The role of personal relationships for doing business in China, and other transition economies, is thus likely to remain an important topic of theoretical and empirical research.

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Appendix: Relevant questions from the HK Company Survey Questionnaire (2007)

Q1 [q41] Compared to HK, how important are personal networks for your company to get things done in PRD?

- Much more important Somewhat more important No difference
 Somewhat less important Much less important

Q2 [q42] How important are the following reasons for your company to fulfil some of its tasks via personal networks in PRD? (1 - very important, 5 - not important)

1 2 3 4 5 To substitute for missing governmental laws and/or regulations

1 2 3 4 5 To substitute for missing formal business rules and procedures

1 2 3 4 5 To respond quickly to customer demands

1 2 3 4 5 To increase company's operational flexibility

1 2 3 4 5 To reduce risks and uncertainties while doing business

1 2 3 4 5 It is culture-determined and a pervasive way for doing business in PRD.

1 2 3 4 5 Others: _____

Q3 [q43] In your opinion, how important are personal relationships between companies operating in PRD and the public officials there for getting the following activities done? (1 - very important, 5 - not important)

1 2 3 4 5 Getting permissions for investment/ production

1 2 3 4 5 Getting permissions for sales in China

1 2 3 4 5 Access to buildings and/or land

1 2 3 4 5 Access to workers

1 2 3 4 5 Access to scarce materials and resources

1 2 3 4 5 Importing machines or materials

1 2 3 4 5 Expansion of company size

1 2 3 4 5 Access to governmental support

1 2 3 4 5 Access to business-related information

1 2 3 4 5 Solving business disputes

Q4 [q44] Please assess the following statement about the future of PRD. (1 – totally agree; 5 – totally disagree)

1 2 3 4 5 Personal relationships will become less important for doing business in PRD, if the institutional framework there is getting better and the market mechanisms are getting more efficient

Q5 [q21] How many 100% owned production plants and production plants under cooperation arrangements does your company have? Where are they located?

100% owned production plants:

HK() Guangdong (), cities*: _____

China (), provinces: _____

Others (), countries: _____

Production plants under cooperation arrangements:

HK() Guangdong (), cities*: _____

China (), provinces: _____

Others (), countries: _____

** If totally more than one, which city in PRD is your most important production location? _____*

Q6 [q22] How important are the following criteria for your company to produce in this city in PRD?

1 2 3 4 5 Cheap production factors (e.g. labour, land)

1 2 3 4 5 Infrastructure for transport and communication

1 2 3 4 5 Proximity to other companies in the same or related sectors

1 2 3 4 5 Tax exemptions or preferential treatments from local government

1 2 3 4 5 Few governmental regulations on production

1 2 3 4 5 Well-established legal systems

1 2 3 4 5 Personal and/or family ties

1 2 3 4 5 Others: _____

Q7 [q23] How important are the following criteria for your company to operate in HK? (1 - very important, 5 - not important)

- 1 2 3 4 5 Qualified labour and new technology
- 1 2 3 4 5 Access to superior business services
- 1 2 3 4 5 Proximity to other companies in the same or related sectors
- 1 2 3 4 5 Few governmental restrictions/ interventions
- 1 2 3 4 5 Well-established legal systems
- 1 2 3 4 5 Well-developed markets
- 1 2 3 4 5 Personal and/or family ties
- 1 2 3 4 5 Positive location image
- 1 2 3 4 5 Others : _____

Q8 [q24] Does your company apply the following forms to organise its production in PRD? If yes, how important are they? (1 - very important, 5 - not important, 0 - not applied)

- 1 2 3 4 5 - 0 Own production site (without legal nature or 100% owned affiliated companies) (1)
- 1 2 3 4 5 - 0 Manufacturing partners are linked by another type of equity relationship (e.g. exchange of shares, joint venture) (2)
- 1 2 3 4 5 - 0 Manufacturing partners are linked just by framework agreements or licenses (3)
- 1 2 3 4 5 - 0 Just placing orders to your company's manufacturing suppliers (4)

Please think of your company's most important producer (own factory, partner or supplier) in PRD, i.e. the producer which produces the largest share of products in terms of value.

Q9 [q25] In which form of production mentioned above is your company's relation to its most important producer organised? *Please use the numbers (1)-(4) in Q8 [q24].*

- (1) (2) (3) skip Q10 [q26] (4) skip Q10 & Q11 [q26&q27]

Q10 [q26] Does your company have framework agreements with its most important producer?

- Yes No skip Q11 [q27]

Q11 [q27] Are the following points covered by framework agreements with your company's most important producer? If yes, are these points fixed in written or oral form?

Covered **Written** **Oral**

- Y/N Description of products
- Y/N Quantity of products
- Y/N Price of products
- Y/N Delivery time
- Y/N Agreement on exclusivity
- Y/N Penalties for breach of contracts

(Please check Q8 [q24]. If the company interviewed does not have any partners (i.e. if Nr. (2)-(3):0), skip Q12 [q31].)

Q12 [q31] How important are the following reasons for your company to choose its manufacturing partners for organising its production in PRD? (1 – very important; 5 – not important)

- 1 2 3 4 5 Required by Chinese laws or regulations
- 1 2 3 4 5 Expertise of the partners
- 1 2 3 4 5 Good experiences in former business
- 1 2 3 4 5 Good reputation of the partners
- 1 2 3 4 5 Existence of personal relationships
- 1 2 3 4 5 Get along with local workers/suppliers well
- 1 2 3 4 5 Get along with public officials well
- 1 2 3 4 5 Others: _____

Q13 [q35] a) How important is PRD for your company's innovation activities? (1 – very important, 5 – not important) No innovation activities in PRD Go to [q39, not shown here].

Importance of PRD: 1 2 3 4 5 3

b) Which city in PRD is the most important innovation location for your company? _____

Q14 [q36] How important are the following criteria for your company to perform its innovation activities in this city in PRD? (1 - very important, 5 - not important)

1 2 3 4 5 Qualified labour and/or researchers

1 2 3 4 5 Innovation structure (e.g. universities, Science parks, venture capital companies)

1 2 3 4 5 Proximity to other companies in the same or related sectors

1 2 3 4 5 Tax exemptions or preferential treatments from local government

1 2 3 4 5 Few governmental regulations or rules on innovation activities

1 2 3 4 5 Well-established legal systems

1 2 3 4 5 Personal and/or family ties

1 2 3 4 5 Others: _____

Q15 [q37] Does your company apply the following forms to organise its innovation activities in PRD? If yes, how important are they? (1 - very important, 5 - not important, 0 – not applied)

1 2 3 4 5 - 0 Acquisition of licenses and/or innovations

1 2 3 4 5 - 0 Reverse engineering

1 2 3 4 5 - 0 Own R&D and innovation activities

1 2 3 4 5 - 0 *Cooperation with partners

* If not applied skip Q16 [q38]; if applied, **Who are partners?** Universities/Research institutes Suppliers

Customers Others: _____

Q16 [q38] How important are the following reasons for your company to choose its partners for innovation activities in PRD? (1 - very important, 5 - not important)

1 2 3 4 5 Required by Chinese laws or regulations

1 2 3 4 5 Expertise of the partners

1 2 3 4 5 Good experiences in former business

1 2 3 4 5 Good reputation of the partners

1 2 3 4 5 Existence of personal relationships

1 2 3 4 5 Get along with local workers/suppliers well

1 2 3 4 5 Get along with public officials well

1 2 3 4 5 Others: _____

Q17 [fs11]. How many employees were/are employed in your company in total?

31/12/2001: HK _____ PRD _____ Other _____

31/12/2006: HK _____ PRD _____ Other _____

next 5 years HK + 0 - PRD + 0 - Other + 0 -

Note: Number in bracket refers to the number of the questions in the original questionnaire.