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Summary

Executive Summary 7
Chapter 1: The Chinese market and its complexity 11
Introduction 11
Overview of the Chinese market....11
Case studies....17
Best Buy....17
Home depot 18
E-bay....19
Common factors in the three analyzed case studies 20
Conclusion....21
Chapter 2: Liability of Foreignness in literature....23
Introduction 23
Hymer and the cost of doing business abroad....23
Offsetting LOF with corporate capabilities 23
The Resource Based View 25
Institutional theories: adapting to the local environment....26
Cultural theories....28
Internationalization process theories 29
Holistic theories....33
Conclusion....36
Chapter 3: Liability of Foreignness in developing countries 37
Introduction 37
Transitioning economies: an overview of market conditions....37
Alternative point of view - Transitioning economies and lower LOF....38
Dealing with stakeholders in transforming economies 38
China: a unique country....42
Market overview 42
What Guanxi is and how it works....43
Corruption, red tape and uncertainty....45
Chinese protectionism 46
HR management....46

Overcoming liability of foreignness in China 48
Institutional advantage 48
Defensive and offensive strategies 49
Adapting strategies and practices to the Chinese market 51
Conclusion 54
Chapter 4: Empirical Analysis 55
Introduction 55
Sample analysis 55
Country 56
Industry 56
Year of establishment 58
Legal entity 59
Export to china before set-up 60
Analysis of drivers 60
Data analysis 63
Analysis of groups 67
Age of subsidiary 67
Country of origin 72
Industry 74
Legal entity 78
Export to China before establishment of subsidiary 81
Conclusion 84
Bibliography 89
ANNEX 1 99

Executive Summary

After four decades of astonishing economic growth China is now the second largest economy in the world, and it's gaining also political and geographical importance in the globalized world. The country is no more, like it has been called, the factory of the world: its economy is undergoing a fundamental transition from one based mostly on the secondary sector to a more advanced one based on services and internal consumption. During this transition, which is far from being completed, China is suffering massive institutional volatility and social upheaval, and the government is struggling in the combined effort to avoid a further slowdown of economic growth, keep public and local debt under control and maintain employment rate stable. Nonetheless the increasing numbers of the middle-class and a booming consumption, as well as the centrality of the market as logistic hub, make China one of the most attractive countries for FDI. Foreign investments reached indeed the record figure of USD 126.26 billion in 2015 (Rossi & Fasulo, 2016).

Despite the attractiveness, China has always had the reputation of a very complex market to approach. Even before the most recent development in its economy the country was considered to be a difficult market also among other emerging economies which are commonly thought to be in general more concerning for foreign companies because of the uncertainty of market conditions and the lack of well-formed institutions (Yildiz & Fey, 2012). Moreover the institutional uncertainty is only one side of the coin, since Chinese culture is very peculiar and entwined with business practices and whoever wants to operate in the market is forced to get in touch with the issue. All these factors brought together create a high level of Liability of Foreignness to which any foreign company is subject, and there are several cases of multinational firms that failed despite the size of their investment or their international experience and knowhow.

The term was coined by Zaheer in 1995 as the set of difficulties and the related additional costs faced by companies in foreign markets. He based her work on Hymer's (1960) and Kindleberger's (1969) studies on internationalization who first recognized the issue. The concept has been studied from several point of view in literature in order to understand both what are the causes and how to overcome its effects. For example according to who supports the RBV theory LOF can be overcome with organizational resources, while according to the institutional theory a company shall adapt to the environment to gain legitimacy and reduce pressure from internal and external stakeholders. When it comes to operating in a foreign country the lack of knowledge about local practices, institutions and culture can give rise to a big disadvantage compared to domestic players, and it's important to understand the market and implement suitable strategies to mitigate LOF. In any case though there is no definitive theory that can describe the concept. It would be impossible to define a single framework to analyze the wide variety of different situations where LOF is involved, and there is no recipe to follow to overcome it. Nonetheless it's possible to narrow down our focus to one part of the phenomenon where the effect of LOF can be stronger, in developing and emerging economies, and eventually to China.

The main difference of operating in emerging markets compared to industrialized ones is the transitional nature of their industrial and institutional environments, which brings enormous opportunities for foreign firms but also high instability and operational uncertainty (Luo et Al. 2002). China in particular presents a very complex environment for foreign companies which are required to understand it and of course to implement suitable strategies to cope with the consequent high LOF. Chinese culture permeate its business environment, where the direct reflection is the importance of personal connection (*Guanxi*) in every aspect of the market, from the relationship with suppliers and clients to the one with government officials. Moreover like in other developing economies the lack of well-established institutions and the uncertainty of laws enforcement increase the volatility and related risks. If we add the widespread corruption and slow bureaucracy it's clear that approaching this market unprepared could be fatal for the success of any enterprise.

The list of problems that can be encountered and their effect on the level of Liability of Foreignness perceived by companies can vary widely not only between different countries, but also among different groups of – or even single – enterprises. In China for example the level of protectionism experienced can vary between industries, in relation to the level of restrictions that the government implemented (Rossi and Fasulo, 2016). Or for instance the level of integration with the environment chosen for the subsidiary can influence the degree of local adaptation and consequently the pressure from different stakeholders, and more in general the cultural distance (Di Maggio & Powell, 1983). I conducted therefore an empirical analysis on data retrieved directly from foreign firms in China to analyze the high variety of drivers of LOF and the way their effect is related to a company situation. One should be aware that these results are not definitive, since the small number of answers that was possible to collect hampers the ability of the sample to fully represent the population. My findings suggest that the perceived LOF is the result of multiple drivers, which affect independently and differently firm's performance. Moreover it appears like the effect of drivers depends also on other variables like the years of activity in China, the type of legal entity chosen, the industry, the country of origin and previous export experience in the country.

Chapter 1: The Chinese market and its complexity

Introduction

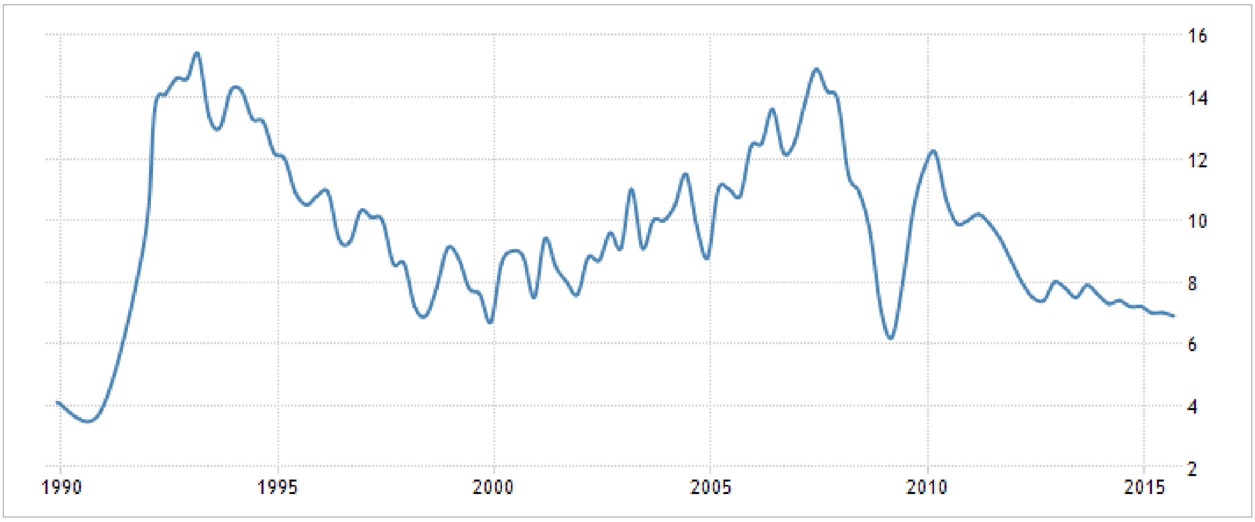
In this first chapter I am going to describe what the main characteristics of the Chinese market are and how it evolved in the last four decades, to become the second largest economy in the world. Despite the astonishing economic growth, which has marked its recent history, China is not, and has never been, an easy market to access and succeed in, due to many institutional and cultural aspects. This is why many companies who enter the market find difficult to thrive and often have to give up. Moreover it’s not only a matter of available resources, in fact also big corporations sometimes can’t find the key to success in this unique environment. I took a few examples of these failures and found some common factors that pushed these companies to eventually leave.

Overview of the Chinese market

The Chinese economy has been growing at a whopping average annual rate of 9.82% from 1989 to 2016 according to the National Bureau of Statistics of China, bringing the country to be the second biggest economy and the second biggest consumer market in world, after the US. In the last couple of years though, due to the reduction of worldwide demand for raw materials and consequent fall of prices of commodities, the growth rate has slowed down to 6.7% in the 1st and 2nd quarters 2016, the slowest growth since the first quarter of 2009 (Husna, 2016) - right after the global financial crisis. Figure 1 shows the annual GDP growth rate in the past 25 years.

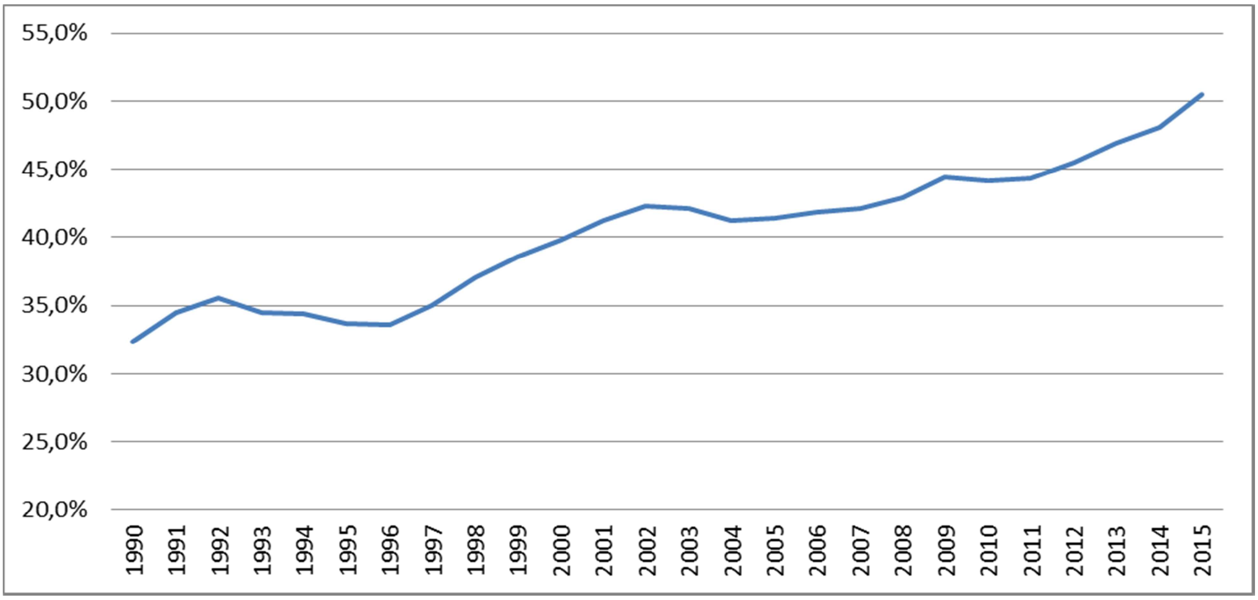
The booming growth in the past 30 years was mostly driven by the industrial sector, as China was becoming the so called “factory of the world”, and huge investments in infrastructure and housing, sometimes redundant, in order to support the incredible expansion of cities around the country. Moreover Chinese GDP benefitted from an unprecedented stream of foreign direct investments that fueled even more the already sustained growth. Still nowadays the secondary sector is a major component of total GDP, and it was only last year, in 2015, that tertiary sector surpassed 50% of the total (Rossi & Fasulo, 2016), as shown in figure 2. If we compare these figures with those of developed economies like the U.S. or even Italy, where the tertiary sector made in 2014 up to 78% and 74.3% of the economy respectively (worldbank.org), we can see how China has still some road ahead.

Figure 1 – China GDP Annual Growth Rate (1990 – 2015)



Source: www.tradingeconomics.com | National Bureau of Statistics of China

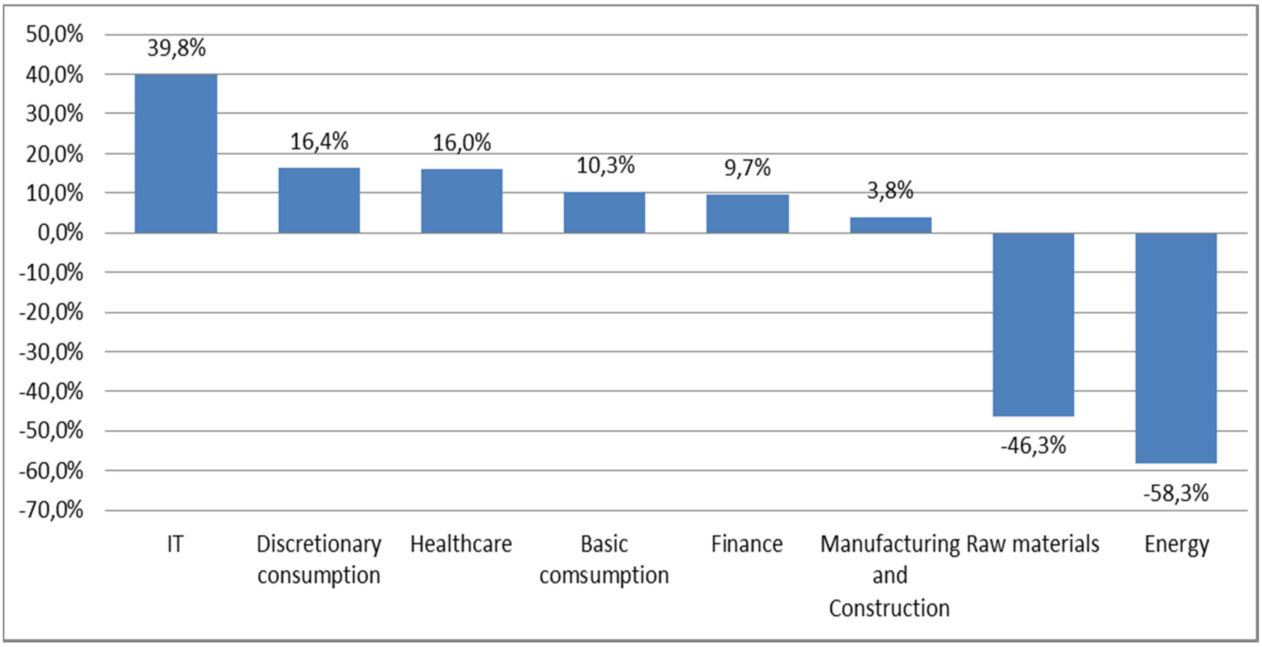
Figure 2 - Services value added in China in the last 25 years (% of GDP)



Source: data.worldbank.org | World Development Indicators

The recent slowdown has exposed all the flaws characterizing Chinese economy. The industrial and mining sectors have suffered everywhere in the world from the struggling economy, but in China where they both are heavily made of state owned enterprises (SOE) - in which inefficiency and overcapacity flourished due to double-digits growth rates and local governments' incentives – these industries have been struggling and have survived only thanks huge amount of debt, which is according to a new Moody's report up to 115% of China GDP (Desai, 2016), and state protectionism, giving origin to many so-called "zombie companies", running only to pay off debt. If Chinese economy is still growing it is because other sectors, as shown in figure 3, are thriving thanks to their competiveness and modern business models based more on value creation than on state intervention.

Figure 3 - Profit in selected sectors of Chinese economy, Growth in 2015

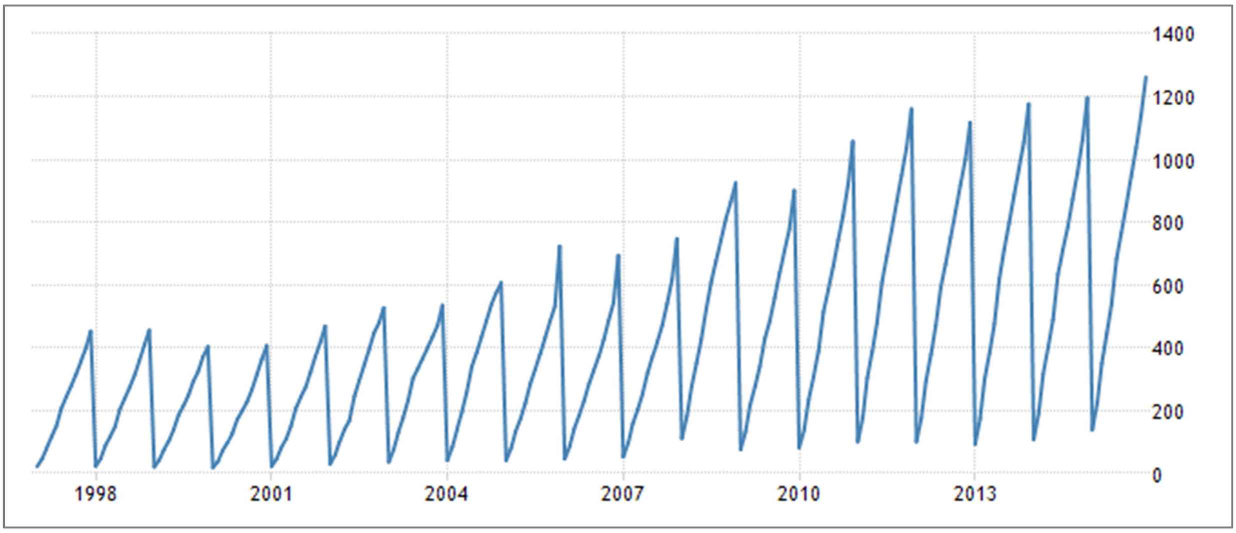


Source: Rossi & Fasulo, 2016 | Wind Information

The Chinese government has understood that the situation is concerning and that it's necessary to adapt to the "new normal" of slower growth and has undertaken the goal of transforming the economy into a fully developed one based on sustainable growth, internal consumption and services. At the same time they are committed to address the structural problems of the secondary sector transitioning to a more modern one based on technology and efficiency and less on state intervention to compete (Rossi & Fasulo, 2016). The undergoing transitioning process is very complex and the political and economic agenda of the government has to take into consideration many stakeholders in order to bring the country as smoothly as possible to a new equilibrium. This is especially true in a huge country like China, characterized by very diverse regions, each with its own local interests, and a culture driven by compromise in all of its aspects. Also investors understood that China is now in a critical phase of its development and the high volatility of markets, especially in summer 2015 and January 2016, is an indicator of their worries.

Nonetheless Chinese president Xi Jinping is committed to make sure that the government's objective of doubling the 2010 GDP level by 2020 is matched. To do so consumption and services must secure their predominance as share of national economy, in order to offset the slower growth in the secondary sector and keep the annual growth rate at the current levels for the next five years. Furthermore the government is sponsoring a development plan for economic integration that should reach not only neighboring countries, but also Central Asia and eventually Europe, called "One Belt, One Road" and inspired to the Silk Road experience in ancient times. The project includes impressive infrastructural works that should help Chinese economy to better integrate with others and reduce the overcapacity structural problems it is facing. The project will be also financed by the newly founded Asian Infrastructure Investment Bank (AIIB), wanted by the Chinese government but co-founded by various nations from the whole world, to "address the daunting infrastructure needs in Asia" (Source: www.aiib.org).

Figure 4 – Foreign Direct Investment in China. USD hundreds of millions. (1997 – 2015)



Source: www.tradingeconomics.com | Ministry of Commerce of the People's Republic of China

China has seen the level of foreign direct investments increase at an incredible pace in the past 20 years and despite the slugging economy and the rising difficulties of operating in the market in most recent years, in 2015 was recorded the maximum total amount ever invested in

Chinese history, USD 126.26 billion (Rossi & Fasulo, 2016) as shown in figure 4, which represents the cumulative foreign direct investment in every single year since 1997. Consistently with the new direction taken by Chinese economic development, also the nature of foreign investments is transforming: compared to 2006, when the share of investments in manufacturing sector was 63.6% vs a 31.1% in services, the situation has basically inverted, with 70.4% in the service sector and 28.3% in manufacturing during the first six month of 2016 (Trading Economics).

Even though the amount of FDI is still increasing, it's undeniable that the pace has decelerated in last few years. This slowing down is certainly due to the overall decrease of Chinese economic growth, but also from a growing protectionist attitude of the government (Rossi & Fasulo, 2016). Even if on one side China has decreased monetary trade barriers in the years, as part of its commitment to open the economy after entering in the WTO, on the other side the non-monetary barrier have increased considerably. In particular several foreign multinationals have been put under pressure by local and national authorities with investigations and fines in the frame of the new antitrust law implemented in 2008. Also in the field of trademark and license protection, not only Chinese law are pretty loose, they are also poorly enforced, especially when it comes to foreign brands. A clamorous example is Apple, who recently lost a trademark lawsuit over the use of the name "IPHONE" on leather products against the Chinese company Xintong Tiandi, who apparently filed their trademark application in 2007 when, according to the court, Apple could not prove it was a well-known brand in China, even though the US based multinational filed the brand for electronic goods back in 2002 (source: www.BBC.com).

But the battle against foreign companies is not fought only in courts, there are many other kind of non-tariff barriers both on the demand side, with control of market through public auctions which consistently favor local companies in their requirements, and on the offer side with limitations to investments in strategic sectors, stricter controls on operations of foreign invested companies. Also the access to credit is of course easier for local SOEs – and this is one of the main reason for the huge debt problem that China is facing. It appears that many companies and institutions in the country perceive local players to have acquired enough managerial maturity and capabilities in order to prosper without the help of foreign investments. This sentiment is also bringing along a rising nationalism in the whole country. Therefore, after a period of warm welcome to foreign companies with several incentives to

FDI in order to boost the economic growth, Chinese government has now changed its strategy in order to ensure that young national firms thrive to the detriment of foreign ones, especially in key sectors like automotive, telecommunications, iron and steel, financial, petrochemical and agricultural.

The institutional pressure on foreign firms is then now at the highest level since the opening of Chinese market to the world and companies who want to invest and succeed must proactively seek for good relationships with all the stakeholder now more than ever (Rossi & Fasulo, 2016). The need for a wide and deep network of relationship in China is not a new thing though, in fact the Chinese value of "Guanxi" – relationship in mandarin – is a pillar of Chinese culture and dominate all aspects of life, including business. Guanxi represents not only a good relationship, it stands for a strong tie with the other party and mutual trust built on exchange of favors, and cannot be ignored by foreign companies that need to consolidate their relationship with government officers, as well as with suppliers and distributors. Failure to do so can make company's life more difficult, to the point of hampering its results.

Regardless the increasing difficulties, investments in china have always being "high risks – high returns" ones, especially now that the economy is in a transitioning phase the risk can be extremely high. Nonetheless returns and risks can vary among different industries: technologically advanced industry, retail and service sectors that are now driving, and will drive in the coming years, Chinese economy are still in a development stage and still offer growth opportunities, even though international and local competition is fiercer and fiercer. Investments aimed to exploit lower labor costs and looser regulations are will face rising difficulties and are maybe not worth anymore. Also the choice of localization is very important, since China is not a single market and different regions within have both different growth rates and market maturity levels, giving opportunities to different players.

It's no surprise that many foreign companies have tried to take a share of the booming economic growth in the past 30 years. The results, however, have not always been successful, even if we don't consider the last period. In fact many companies who attempted to enter the Chinese market, even among those who did it in the golden age of FDI inflow in China and could benefit of important incentives from local and national authorities, didn't experience great success, and in some cases the output was a disaster. Despite several stories of success, a number of multinational corporations have experienced crushing failures. In the next section, we analyze a select few of these cases, bringing together common factors that led to their subsequent failure.

Case studies

Best Buy

Best Buy is one of the largest US consumer electronics retailers by revenues (statista.com) and since its creation has been focusing on a price competitive strategy, surviving more than one price war throughout its existence. With the arrival of online retailers however, the company has been facing a lot of pressure, due to its cost disadvantages compared to the main online competitors, Amazon.com above all (Pernet & Nunez-Candiani, 2012). Best Buy found itself reevaluating its own competitive advantage in the US. The company realized that the only way to maintain its market share, and eventually avoid bankruptcy was to re-focus on what online retailers cannot provide, a consumer-centric strategy. Nowadays Best Buy provides additional warranties and in-home installation and configuration, together with knowledgeable employees' assistance. Nevertheless this strategy is having a drawback effect, since is helping Amazon in increasing its sales, as Best Buy's store are becoming Amazon's showrooms. It's very common for clients to go checking products before buying them online for a cheaper price. With these threats in the domestic market, Best Buy have decided to increase its efforts in foreign markets.

Due to its economic and social factors, China represented a very good opportunity for the company's growth in foreign markets; moreover they had already operated in China for purchasing purposes, so the market was not completely unknown. In 2006 Best Buy acquired China's third largest electronics retailers, Five Star. With this acquisition the company obtained immediate retail presence in the market and a strong management team familiar with local consumers. By 2011 they were operating 164 Five Star stores in the whole China and 8 Best Buy branded stores in Shanghai. Best Buy branded stores in China were organized and managed in a very similar way to US stores; sales persons were qualified and were not biased by commissions, as in the majority of Chinese retailers' stores. Their differentiation strategy relied, as in the US, on services like installation, repair work and guarantees: a level of service that you can hardly find in Chinese market.

One big problem though was the lack of brand recognition, and they had to invest a lot in marketing to reduce this disadvantage. They also invested in some large flagship store in the city center. The settlement in Shanghai downtown, and not in the suburbs like in US, was led by the fact that most of its competitors were located in the same area. The company made a mistake with the choice of stores' location though: some of them for example were located far from metro stations, making them not conveniently reachable. Despite huge investments, Best Buy operations in China haven't been profitable, and although they cut their expenses along in the years, by the end of 2011 all their 8 branded stores were closed.

Chinese electronic retailers have a completely different strategy from their US equivalents. They manage to be incredibly price competitive by renting partially or entirely their store space to manufacturers and passing costs directly to them. Such a strategy consequently is highly dependent on a commission-based model, which bring higher sales per employee. In addition to Best Buy's cost disadvantage, the company also suffered from lower returns per employee. It's easy to understand how Best Buy's business model was not as profitable as they had expected. Furthermore, Chinese consumers perceived Best Buy's prices to be higher than its local competitors, even if prices were quite similar. The origin of this was partially due to the fact that Chinese people perceive foreign brands as more expensive, but also on the company's business model itself. Their non-commission based strategy resulted in a fixed price policy, which was in contrast not only with their main competitors' strategy (which allow sales persons to apply discounts), but also with the Chinese practice of negotiating prices. This is so embedded in Chinese culture that sometimes a product is more likely to be purchased if a deeper discount is applied, even if the final price is higher or equivalent.

Moreover, not only were Best Buy's prices perceived to be higher, but their value proposition was not perceived to be better than Chinese competitors. Local players in fact do not usually provide additional services because consumers can buy the same services in small convenience store for a better price. Even if the company's differentiation strategy is valued by American customers, the same is not true for Chinese ones. Best Buy found itself without any competitive advantage and facing several disadvantages toward Chinese players. "Best Buy represented the shopping, not purchasing, stage of consumption," sums up consumer researcher Mary Bergstrom (Young, 2011).

Home depot

China's homeownership has been growing with incredible pace in the last decade, and with a growing middle class, the homeownership is expected to increase in the next few years, despite the economic slowdown. Moreover Chinese culture is embedded in what we can define as “everyday ingenuity and thrift” (Carlson, 2013). In this context looks like Home Depot, America’s largest home improvement company and leader in the DIY market, would thrive. Instead, after having entered the market in 2006 with the acquisition of a local firm, the company was forced to retreat after seven years of struggle.

There are different reasons why this happened. One reason is the labor cost in the country. Often in China it is more convenient to hire a handyman to accomplish the job, instead of doing-it-yourself, especially if you are a new member of the middle-class and you want to demonstrate your recently achieved economic condition. A second reason is the nature of housing market in China: especially in big cities where prices are booming, people buy houses more as an investment than to live in, and thus have few reasons to improve them. Moreover “Chinese consumers have no role model from older generations” (Wang, 2011). Homeownership was almost non-existent in China about 20 years ago, so the practice of home improvement is relatively new. Home Depot’s business model is to provide tools and consultations for customers, providing them with the means to complete their home improvement projects. This strategy is based on the assumption that customers have their own projects—an assumption that does not necessarily hold for people in China.

That’s why IKEA, the Swedish furniture giant, on the contrary is growing very fast in China, riding the market’s incredible boom. “Their Western-style showrooms provide model bedrooms, dining rooms, and family rooms showing how to furnish them” (Bhasin, 2012), and allow Chinese consumers to experience and purchase a western life-style, which is exactly what Chinese people are looking for in such a store.

E-bay

E-bay (China) was one of the first companies to enter into the Chinese C2C online market, and given the international experience of the company, which had already successfully operated in several foreign markets, it was expected to succeed in China. Their main competitor, who entered the market later, was a local company owned by the e-commerce giant Alibaba and ended up being market leader TaoBao nowadays. E-bay instead quit and left the Chinese market by the end of 2006.

The competitive disadvantage between E-bay and TaoBao was not in the US company business model, which was eventually copied by the latter: it was in the website’s functionalities available for users. E-bay in fact didn’t provide as TaoBao any embedded instant messaging platform in their website that allow consumers to see if a seller is online and immediately communicate with them. This feature is very important for Chinese consumers, which value the possibility to directly contact sellers in order to establish a trust relationship with them before buying anything. This is due to two main factors: the first is the diffusion of counterfeit products and fraud, together with “the lack of a well-established legal infrastructure to protect online transactions” (Ou & Davison, 2009). The second is the widespread culture of Guanxi in the Chinese market. Guanxi as mentioned before represents the mechanism of social connections in Chinese culture; it could be compared to what a business network represents in the western culture, with the difference that it’s not only related to business. The possibility to establish a direct connection with the seller, before making a final purchase online, was an important driver in TaoBao’s success.

Moreover E-bay (China) was managed by foreign managers who didn’t know the local market and who invested a lot of money in the wrong way. For instance, after they entered the market the US Company started an aggressive advertising campaign on online major portals. TaoBao’s answer was a massive TV ads campaign: Jack Ma, founder of Alibaba, knew that more Chinese small business owners were more likely to watch TV rather than surfing the internet (Wang, 2010). E-Bay (China) lost its fight against TaoBao because it was more product-centric than customer-centric, and eventually the Chinese company attracted all E-Bay’s unsatisfied customers with a better value proposition. According to a Beijing-based commentator “The road to Internet riches in China is paved with corpses of American giants, and the body count continues to grow” (Ou & Davison, 2009).

Common factors in the three analyzed case studies

If we look at the mentioned cases, even if every company had its own experience, we can track down some common factors. Let’s first review what have been the main problems that each company faced:

- *Best Buy* offered to Chinese consumers the same value proposition they were offering in the US, to realize that Chinese people were not valuating it enough to pay the higher prices the American company was charging for (even if listed prices were almost the same, Best Buy’s were not negotiable).

- *Home Depot* wanted to provide the same product with the same format they were providing in their home market, without understanding that Chinese consumers, despite the fact that getting by is part of their culture, were not looking for this kind of offer, whether because there were no interest in improving or because there was no history of household improvement in the country.

- Although *E-Bay* was the first entrant in the Chinese C2C market, they were caught in fierce competition with a local player. TaoBao at that time could not be compared in term of size and financial resources, but they understood better what Chinese consumers needed. The US giant instead kept using their standardized global website without adapting it to the local market, and invested its larger resources in the wrong way.

As stated by Carlson (2013, p.1) “While the causes are as varied as the industries themselves, a pattern can be discerned among the biggest failures in China: an inability to grasp just how different — and cutthroat — the Chinese market can be.” These companies, and many others like them, entered the Chinese market with the assumption that consumers would behave in the same way as they do in their home market. In other words, they didn’t know or they didn’t understand the market they were entering into and therefore they couldn’t recognize the correct strategy to adopt in order to achieve positive results. This inability to grasp the key driver of success in the market is a big disadvantage towards local players, which in contrast know very well the market and its mechanisms.

Conclusion

In literature the disadvantage suffered by foreign companies who operates in the market is referred to as Liability of Foreignness (Zaheer, 1995) and four categories of costs can be framed in the concept: 1) costs directly associated with spatial distance, such as the costs of travel, transportation, and coordination over distance and across time zones; 2) firm-specific costs based on a particular company's unfamiliarity with and lack of roots in a local environment; 3) costs resulting from the host country environment, such as the lack of legitimacy of foreign firms and economic nationalism; and 4) costs from the home country environment, such as the restrictions on high-technology sales to certain countries imposed on US-owned MNEs. While this list is not exhaustive, it identifies key sources of additional costs facing foreign organizations operating abroad (Moeller et Al., 2013). We will now see how the definition evolved in time, from when it was first coined to the most modern theorizations and interpretations.

Chapter 2: Liability of Foreignness in literature

Introduction

Even though the term liability of foreignness (LOF) was coined by Zaheer only in 1995, his work is largely based on Hymer's (1960) and Kindleberger's (1969) studies on internationalization of firms in the sixties who "recognized that transaction costs are greater for foreign firms than for their domestic counterparts because of their foreignness" (Luo & Mezias, 2002, p.218). In this chapter, I review the core theories that stem from Hymer's work on LOF: the concept has been studied from several point of view and while there is no definitive theory to describe the phenomenon, it is interesting to nevertheless mention and review the most common points of view that appear in the literature.

Hymer and the cost of doing business abroad

As mentioned, the first who wrote about disadvantages for foreign companies in competing with local firms was Hymer (1960), who defined them the costs of doing business abroad. He was convinced that one factor influencing internationalization is the existence of entry barriers, intended as disadvantages towards native companies. These disadvantages, according to Hymer (1960), are due to both foreign exchange risks and lack of knowledge of the most common business practices and market conditions. As stated by the author, "National firms have the general advantage of better information about their country" (p. 34), and these information could be very expensive to acquire for a foreign company. It is also true that this cost can be considered a fixed one, therefore once paid, the disadvantage should be countered.

This is not the only disadvantage faced by foreign firms though. Hymer (1960) himself says that much more relevant —and permanent— is the discrimination a foreign company face, "by government, by consumers, and by suppliers". Sometimes this discrimination is voluntary, like in case of custom duties, some other times is not, for example the preference for local brands by consumers. In any case these disadvantages are difficult to measure precisely, and sometimes also to identify, even if they are extremely relevant.

Offsetting LOF with corporate capabilities

Kindleberger (1969) was convinced that if the world was characterized by perfect competition, foreign direct investment would no longer exist: if markets work effectively and there are no barriers in terms of trade or competition, firms would have no incentive to invest abroad. Not only foreign firms must have certain advantages that give them incentive to invest, but also the market of these benefits has to be imperfect (Denisia, 2010). Many authors who worked on the liability of foreignness focused in fact on finding what advantages are more effective to overcome it. Among the earliest studies those of Caves (1971) and Buckley and Casson (1976) tried to find these solutions identifying the strategic advantage in intangible assets. Buckley and Casson (2009) underlined how internationalization activities were concentrated mostly in "knowledge-intensive industries, characterized by high levels of research and development (R&D) expenditure and advertising expenditure, and by the employment of skilled labor"(p.1564), explaining how managerial skills and coordination are necessary for a company to enter in foreign markets, especially if very different and distant.

Caves (1971) maintained instead that a company is willing to invest abroad only if it's in possess of some unique assets, which must necessarily satisfy two conditions: they must be commonly available among the company and "the return attainable on a firm's special asset in a foreign market must depend at least somewhat on local production" (Caves, 1971, p.5). According to the author, knowledge as a core competence is a perfect example of this kind of assets. Knowledge is embodied in company's culture and is supposed to be widely available among the company. Moreover it can be transferred, even if not always entirely or with the same effect, also to other markets in which a firm intend to invest. Knowledge transferability is not enough though, because local enterprises also have their own knowledge, and it's specifically focused on the local market. This is why the information advantage is not enough for a firm to invest in the market: the advantage have to be at least partially dependent on local production.

According to Caves (1971) product differentiation can be identified as the form of "rent-yielding knowledge" that best represent the need of local production in order to offset liability of foreignness. First of all we can recognize how differentiation respect the first condition, because it's a product characteristic very clear not only among the company, but also among stakeholders; in fact sometimes is really part of the company's image. It is also easily transferable to other markets at a minimum cost. This advantage also depends on local production to be effective, as historical evidence shows that firms generally first test a market with export and then switch to local production "for better adaptation of the product to the local market or the superior quality (or lower cost) of ancillary service that can be provided" (Caves, 1971, p.7).

The Resource Based View

Caves studies can be easily framed in a larger stream of research taking inspiration from Barney's (1991) Resource Based View (RBV) theory, according to which competitive advantage is founded on firm's resources and capabilities. The RBV follows two assumptions: first, companies may have a different set of resources, and their advantage can be built on some unique ones; second, resources shall be at least partially immobile, allowing companies to have sustainable competitive advantage based on those resources (Barney, 1991). Firm-specific advantages can help a foreign company to overcome liability of foreignness (Denk et Al., 2012) especially, as suggested by Zaheer's findings, when a firm's competitive advantage reside in its organizational capabilities: for foreign subsidiaries "imported organizational practices may be a more effective way […] to overcome the liability of foreignness than imitation of local practices" (p. 360) that are not part of parent's expertise. Cuervo-Cazurra et al. (2007) indeed found that internationalization costs are higher if (1) resources that generate firm-specific advantages cannot be transferred abroad, (2) firm-specific resources in the home country turn out to be disadvantages in the host country, or (3) the firm lacks complementary resources required to successfully operate in the host market.

According to some authors, large MNEs importing their capabilities to the subsidiaries not only can manage to overcome liability of foreignness, but also to have competitive advantage over local firms, thanks to their global network and expertise that smaller native companies don't have. Hymer (1960) himself considered this possibility. Starting from the contrast between these results and many other findings that show instead how foreign companies suffer from liability of foreignness, Nachum (2003) argued that the firm performance in a foreign market is the balance between the disadvantages of being foreign and the superior advantages of MNEs. His study revealed that liability of foreignness doesn't always results in low performance. "Under certain circumstances the superior advantages of MNEs outweigh the additional costs associated with foreign activity, leading to superior performance of MNEs.

Barnard (2010) argued instead that sometimes firm-specific capabilities are not appropriate or not enough developed to overcome liability of foreignness in a specific host market. This is the case for example of multinationals from developing countries that try to enter in more developed markets; these companies, due to their development in less regulated market, where usually competition is weaker, would need to overcome both liability of foreignness and a generally weaker capability base. Barnard (2010) maintains that resources available in the market are an effective way - even if not optimal - to overcome both the disadvantages. Specifically she mentioned local workforce and local suppliers can provide the lacking competencies. It's worth to notice that neither of these two resources are purely market-based, and even if they start as contractual relationships, they are likely to become with time more relational. "The hybrid transactional/relational nature of these relationships is probably a key reason why they are so effective" (Barnard, 2010, p.169).

Institutional theories: adapting to the local environment

While liability of foreignness was initially closely related to, if not completely synonymous with, the costs of doing business abroad, Zaheer (2002) finds a distinction between the two concepts. Costs of doing business abroad, as defined by Hymer (1960), are basically a set of market-driven costs; Zaheer (2002) instead focused on the more suitable structural/relational and institutional costs of doing business. Structural/relational costs are associated with a foreign firm's network position in the host country and its linkages to important local actors, while institutional costs affect the legitimacy of the foreign firm, as well as the extent of local learning the company needs to engage in (Zaheer, 2002; Kostova & Zaheer, 1999). A distinction is also remarked by Sethi and Judge (2009), who argued that costs of doing business abroad include all the costs of cross-border operations at the subsidiary-level, of which liability of foreignness is just one component.

Institutions had already been recognized as drivers of LOF by Kindleberger (1969) who highlighted how, even if "the relationship of governments to the international corporation is asymmetrical" (p.193), both the home country and the host country can make pressures on the international company. As the home country will try to influence company behavior abroad through the parent in its own country, the host country has many instruments to exert pressure on the corporation through the subsidiary. We can assume that the host country is more likely to take actions that, if possible, give advantage to local firms instead of foreign firms.

Vernon (1977) recognized the stigma of being foreigner in a growing local bias against foreign firms representing a specific disadvantage facing companies operating in a foreign market and attributed the local bias to host governments and domestic firms viewing powerful multinational corporations as threats to their countries' technological and industrial development. Zaheer and Mosakowski (1997) suggested that liability of foreignness is a form of public stigmatization and is a function of social and cultural barriers. This view is shared by Eden and Miller (2004), who identified one of three categories of liability of foreignness as discrimination hazard, originated by unfavorable treatment from local institutions and stakeholders in general. Moreover the costs resulting from discriminatory behavior from local stakeholders - unlike the unfamiliarity with local business practices (Petersen & Pedersen, 2002) - are not likely to decrease with elapsed time.

Taking inspiration from Vernon (1977), Zaheer (1995) and Zaheer and Mosakowski (1997) focused on MNEs operating in highly developed economies with powerful institutional environments (Luo and Mezias, 2002). These studies argued that foreign firms could experience liability of foreignness if they wouldn't understand or follow local institutional norms. In fact, even if laws express somehow the differences in cultures between the foreign firm and the local environment, they are equally available and clearly stated for both native and foreign companies. The greatest degree in information asymmetry then resides in non-written rules, or norms (Kostova & Zaheer, 1999), also defined as the rules of the game by North (1990). Norms are embedded in the local culture and, even if foreign investors try to adapt their strategy and operations in order to conform to them and gain legitimacy among local stakeholders (Di Maggio & Powell, 1983), often the country-specific nature of them makes it difficult to fully understand and implement accepted organizational practices. Failing to implement socially accepted practices can drive friction between the organization and local stakeholders and possibly trigger penalizing actions from powerful institutions; tensions with the business environment and coercive actions from local institutions can generate liability of foreignness. Calhoum (2002) suggests that different level of corruption might be an example of unwritten rules; a firm based in a country with low level of corruption for instance is likely to be disadvantaged by the lack of complete understanding of this relevant phenomenon.

Also Elango (2009) analyzed foreign firms behavior in a highly regulated market and their use of boundary spanning; the term is described as ‘‘...those roles that involve procuring resources and disposing of outputs, relating the organization to its larger community, and adapting the organization to the future by gathering information about trends ...’’ (Scott, Mitchell, & Birnbarum, 1981, p.244). Elango (2009) maintains that companies can reduce the effects of liability of foreignness by effectively processing information acquired from the environment and then transmitting back to the local stakeholders the right favorable information about the firm. According to him the ability to handle these two tasks increases company's chances of survival in the foreign market. Elango's (2009) study shows that operating with a wider product range, to gain exposure and increase the chances to meet local tastes, and the affiliation with business groups to share resources and tap knowledge are effective strategies to minimize the effects of liability of foreignness.

Cultural theories

We can notice how institutional theories are often connected to cultural differences. The capability to understand local norms depends mostly on the knowledge about local cultural environment. Zaheer (2002) even argues that cultural distance is a concept that can be included in the broader framework of institutional distance. According to Calhoum (2002) foreign firms are subject to 2 kind of uncertainty when entering the market, external uncertainty, streaming from a different set of stakeholders who do not share the same cultural background, and internal uncertainty due to local staff values that are not necessarily in line with company practices. According to Eden and Miller (2004) internal and external uncertainty are part of the same category of liability of foreignness, that they call relational hazard. Moeller et Al. (2013) instead went even further, distinguishing between tangible and intangible, for both internal and external factors. While external uncertainty can be framed into institutional theories, internal should be encapsulated into cultural distance theory.

Foreign ventures face a big disadvantage compared to native firms when trying to manage their local hired employees. The formers in fact struggle between the required internal consistency with parent's organizational practices and the need to local adaptation (Bartlett & Ghoshal, 1989). Moreover staff may be unwilling to undergo corporate norms and practices, and could question or sometimes challenge management decisions (Kostova & Zaheer, 1999). Even when staff agree to adopt organizational values the unfamiliarity with local employees' culture can decrease management's ability to lead them and to obtain their best performance, as found out by Newman and Nollen (1996): using Hofstede's (1980) dimensions of national culture, they studied how a greater fit between practices used at the organizational level and national culture can be associated with higher performance of the subsidiary. Their results support the notion that national culture seems to mediate the effectiveness of work practices at the organizational level. Nationality, and its culture together, could be a driver of liability of foreignness itself (Moeller et Al., 2013): country of origin could influence consumers' response to firms' products or brand and can have a significant impact on quality perception. The country of origin though could be a misleading variable and must be taken into consideration carefully due to what Bartlett and Ghoshal (1989) defined administrative heritage, or the homogeneity of organizational practices among companies from the same country. This heritage may differ between different countries, and additional costs for foreign enterprises could be due to these practices and not from foreignness.

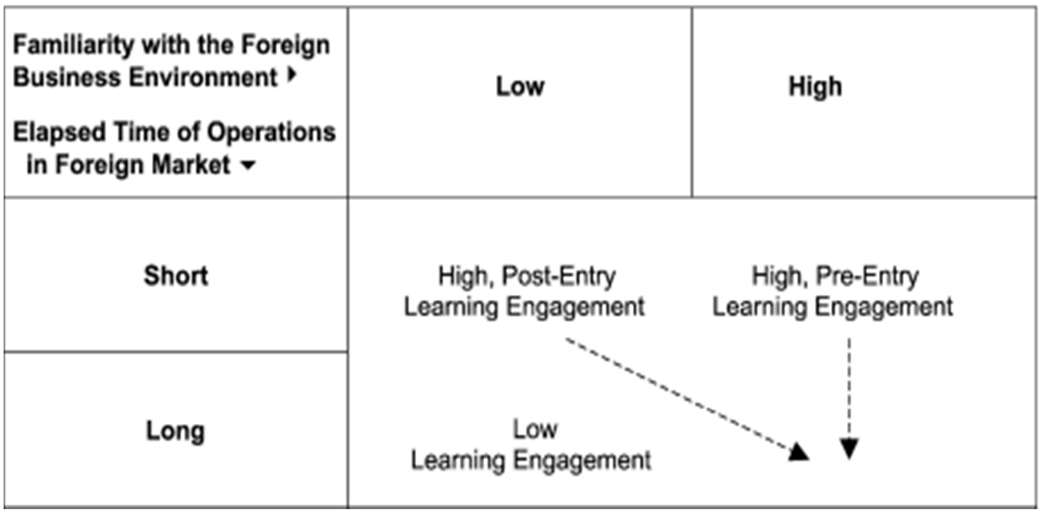
Also Kogut and Singh (1988) used Hofstede's model as a basis for their studies. They used for the first time the concept of cultural distance to measure organizational performance, arguing that rising managing costs faced by the corporation are associated with the increase of cultural distance between the country of origin and the country where the subsidiary is set up. Other studies later argued that Schwartz's model (1994) is more suitable than Hofstede's, because more complete. Nonetheless more recently Mezias et al. (2002) showed that the use of these two models of national culture to characterize phenomena at organizational level is biased and results in systematic errors. And actually not only Kogut and Singh (1988), but Hofstede (1980) himself stated that the use of national culture dimensions is not ideal to be applied to organizational studies, and a measure of cultural characteristic at corporate level would be more suitable.

Internationalization process theories

Given the important effect that cultural and institutional distance have on a company operations in a foreign market recent studies have focused on strategies aimed to increase the corporate knowledge about the host market. Petersen and Pedersen (2002) developed a conceptual model to study how the learning engagement affects the liability of foreignness with the goal to identify the best solution to reduce it. Taking inspiration from Zaheer and Mosakowski (1997) who first suggested that liability of foreignness is likely to diminish with elapsed time, Petersen and Pedersen state that the learning engagement is influenced by two variables: the elapsed time and the perceived familiarity of the entrant firm - and its management – with the foreign market. The learning engagement has been defined by the two authors as the way managers decide to tackle the lack of knowledge about the new market. How do the two mentioned variables affect the learning effort? First, the effort itself is only triggered by the perceived unfamiliarity with the market; second, the period over which the effort is spent – the elapsed time – is likely to affect the quality of this engagement. It is important to notice how according to Petersen and Pedersen (2002) time itself is not enough to bring knowledge to the firm. If the company perform no activity in the foreign market, or if it is not open to change – and learning – the effect of engagement would be close to zero. Management can therefore choose among three different strategies of learning engagement:

sometimes managers can perceive the foreign market similar to their home market, or the company's global strategy do not need local adaptation; in this first scenario the firm will not engage in any learning. If instead a learning strategy is needed, management can decide for a pre-entry learning or for a post-entry learning strategy. Of course in the first case the familiarity with the local market will be higher from the beginning. On the other hand if a post-entry learning has been chosen, the familiarity will be low right after the market entry, but is likely to increase with elapsed time (Figure 5).

Figure 5 – Learning Engagement Strategies



Source: Petersen & Pedersen (2002)

In any case foreign firms are likely to become more and more integrated with the local environment with elapsed time after they have entered the market, and this remain true despite the introduction of the newest technologies: Nachum and Zaheer (2005) find that despite the economic integration due to technological advances, new technologies do not significantly reduce liability of foreignness in the context of knowledge-seeking motivations for investments in foreign markets. In other words, direct investments are still the only way to tap untouched sources of knowledge (Denk et Al., 2012). Besides what a company perceives, market unfamiliarity – also defined unfamiliarity hazard - is an actual source of disadvantage and costs arising from it are due to incorrect market assessment, insufficient and erroneous information and inadequate knowledge of the host country's culture, norms, values, and business practices (Eden and Miller, 2004).

According to internationalization process theorists associated with the Uppsala school Johanson and Vahlne (1977), one common pattern for market entry is a mix of pre and post-entry strategies. Usually entrant firms learn about the foreign markets in two ways, first through local operators from which they can acquire knowledge, secondly by expanding to "foreign markets of successively greater psychic distance" (Petersen & Pedersen, 2002, p.341). Only later they would venture into any establishments in farther markets. This internationalization strategy allows companies to reduce substantially the unfamiliarity with the target market both before entering it, thanks to its knowledge about similar markets, and after the entrance by tapping local partners. Even Hymer (1960) himself suggested the use of licensing or local distributors to first enter a foreign market over the use of foreign direct investments: in fact local licensee or distributors wouldn't be hampered by liability of foreignness. Moreover this strategy give the chance to the foreign investor to tap its local partner for market information and knowledge.

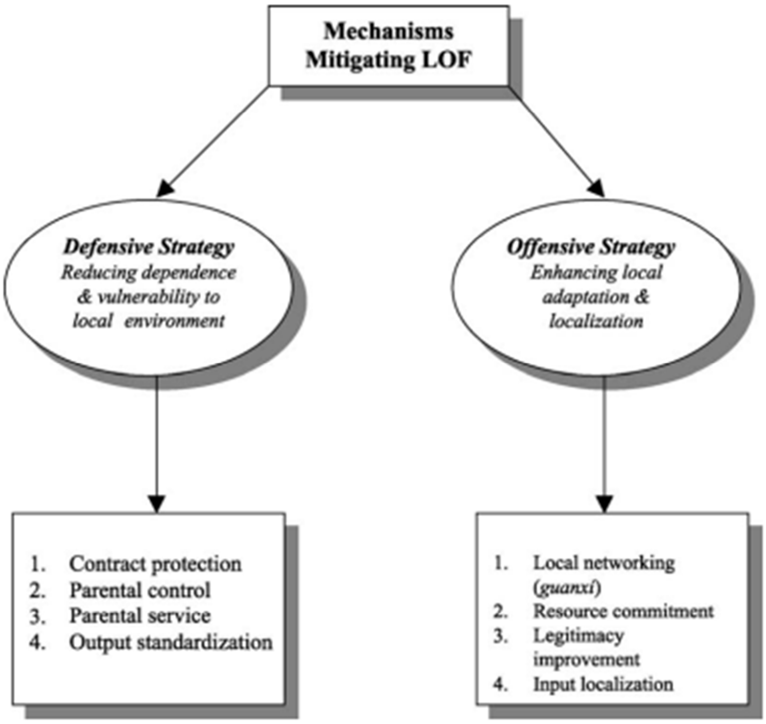
Also Casson (1994) argued that learning processes are influenced by a sort of economies of scope, and firms who had already internationalized have less difficulties in learning about foreign environments. About the same issue Barkema et al. (1996) discussed how early expansion in geographically closer market before moving to farther ones could lead to more successful patterns for internationalization than a diversified strategy. Zaheer (2002) though argues that this kind of sequential pattern may not contribute to gain local market knowledge because of the opportunism and moral hazard issues involved in agency relationships. Moreover these studies do not take into consideration that also local companies are always involved in learning processes: the focus then should be on relative learning rates of foreign versus local firms (Zaheer, 2002).

Mezias (2002) warned that an important factor to take into consideration when formulating a strategy to improve the adaptation is the staffing strategy: the use of locals or expats in executive positon can affect the liability of foreignness. For example if top management is staffed with more locals, adaptation is likely to be smoother thanks to a better understanding of local practices. Adaptation is also linked to another factor, which is the relationships between parent and subsidiary; subsidiaries in general face conflicting pressure to adapt locally and maintain internal consistency with parent's organizational practices (Rosenzweig & Singh, 1991). The degree of local adaptation resulting from this internal conflict influences liability of foreignness. Other drivers affecting liability of foreignness are finally the level of global operations, which may proxy the degree of international experience, and the involvement in the host country, which could affect, again, the adaptation to the environment (Mezias, 2002). Sometimes to reduce LOF is not necessary to adapt organizational practices themselves, as shown by Sofka and Zimmermann's (2008) findings. They argue that the degree of liability of foreignness is not uniform in the host country. In particular, according to their study, regional economic differences in a country can be exploited by foreign companies to mitigate the effect of liability of foreignness. In a situation of economic stress for example local customers could re-evaluate their decision patterns, giving foreign firms and their products a window of opportunity. In other terms, potential customers in economically depressed regions evaluate products more objectively and rely less intensively on country of origin stereotypes (Sofka and Zimmermann, 2008).

An alternative view is provided by Luo et Al. (2002), who maintain that a company has two options to minimize liability of foreignness, offensive or defensive strategies (Figure 6). Defensive mechanisms consist of (1) contract protection; (2) parental control; (3) parental service; and (4) output standardization. Offensive or proactive mechanisms comprise (1) local networking; (2) resource commitment; (3) legitimacy improvement; and (4) input localization. The main difference between these two sets of options is the strategic goal; while defensive mechanisms are aimed to reduce company's interactions with the local market, minimizing risks, offensive actions are employed to maximize local adaptation and increase its legitimacy in the market environment.

Luo et Al. (2002) argue a defensive strategy helps to reduce costs, offensive strategy instead increases returns. In their study they analyze the effect of two strategies – contracts as a defensive one and local networking as offensive – in the Chinese market. Their findings show that not only these mechanisms have the expected effect (reducing cost the former, increasing returns the latter), but also they are not adversary and can be used in a complementary way. Their findings in fact show how the better performers in the market are those foreign companies who use both the methods.

Figure 6 – Different Strategies to mitigate LOF



Source: Luo et Al. (2002)

Holistic theories

Several studies analyzed the nature and effect of costs of doing business abroad from different perspective – e.g. institutional, RBV, etc. – but Sethi and Guisinger (2002) argued that most of them “represent only isolated snapshots of the phenomenon and have failed to view this liability holistically” (p. 224). The traditional dualistic view of liability of foreignness, who frame the disadvantages a foreign subsidiary faces compared to the local competitors, is “static and constricted” and not suitable to describe the whole set of costs of operating in an international business environment (IBE), which can be defined as an enhanced conceptualization of liability of foreignness (Sethi & Guisinger, 2002). In fact the globalized market is way too complex and companies, also native ones, have to deal with several volatile factors who cannot be studied only by considering the interactions between the two firms. Since the original conception of liability of foreignness is limited to the foreign subsidiary within a host-country’s context, it does not consider other costs arising from increased multi-country operations and complex interdependence of the global environment (Kobrin, 1995).

Since IBE is the turf where firms compete on the global market, and given its high complexity and volatility, good reading capabilities, defined by Sethi and Guisinger (2002) as “scanning, interpretation, synthesis and analysis” (pag.224) are considered by the authors a must-have to overcome the liability of foreignness and sometimes even an enhancer of competitive advantage towards local enterprises. Because reading skills are connected to strategy formulation and implementation, internal development is ideal, but it’s not the only way to acquire them: also partnerships, networks, localization and commitment to demand’s matching resources are meant to better read the environment. Nevertheless IBE reading capabilities by themselves cannot represent a competitive advantage, the firm’s core competencies are of course the major driver. Only in fast-paced and highly volatile industries reading capabilities may be a core competence that allows companies to quickly understand market changes and adapt accordingly. Foreign companies thus should leverage their international experience and network, the so-called reading skills, to contrast the liability of foreignness (Sethi and Guisinger, 2002).

A step further has been taken in the holistic perspective by Sethi and Judge (2009). They in fact maintain that not only the whole set of costs of doing business abroad must be taken into consideration, but also the benefits of doing business abroad should be. Their framework distinguish between costs incurred from the subsidiary while doing business in the single host country - liability of foreignness – and costs incurred when interacting with the international environment outside the host country - liability of multinationality. The same distinction is applied to benefits, or assets, which can arise in the host country context or from international activities of the subsidiary (Sethi and Judge, 2009). The impact, positive or negative, is thus the combined effect of all these forces.

Table 1 – Summary of Theories Analyzed

Theory	**Brief description**
Resource Based View	A firm's competitive advantage, and thus its ability to offset LOF is founded on its resources and capabilities.
Institutional theories	Institutions push companies to adapt in order to gain legitimacy and reduce the LOF generated by an unknown or even hostile environment.
Cultural Theories	Nationality, and its culture together, could be a driver of liability of foreignness itself (Moeller et al., 2013).
Internationalization process theories	The way companies engage with a target market, and the strategies adopted once entered, will influence the level of LOF actually faced.
Holistic theories	The dualistic view of LOF seen as the disadvantages faced by foreign companies compared to local ones is no more suitable for a globalized world and should then be replaced by wider concepts like the IBE.

Conclusion

We saw that liability of foreignness has been analyzed from several perspective, summarized in table 1, and even if the concept has been engaged from different levels of analysis and studies have sometimes found conflicting results I believe there is no definitive theory that can describe the phenomenon. The global market include such a huge variety of situations and environment that would be impossible to define a single framework that manage to describe all of it without losing a significant level of detail. Scholars find themselves then in front of a trade-off when conducting a new research or developing a new theory: they can focus on a very specific aspect of the matter, or they can renounce details in favor of a more comprehensive view. Of course this choice can be positioned on a continuum of specificity and can be difficult to assess where exactly a research is collocated on it.

Several studies taken into consideration so far, even if not explicitly, target developed market. The increased importance of emerging economies though requires both for academic and business reasons theoretical models that are applicable to all markets. Hence makes sense to wonder if the same empirical results and consequent conclusions are still valid in developing countries. We will now first review some of the most recent researches that focused specifically on developing – or transforming – economies, and later we will analyze the Chinese market. China in fact is nowadays the second global economic power after the United States and its unique culture and business practices strongly influence the strategy of local and foreign companies operating in the market.

Chapter 3: Liability of Foreignness in developing countries

Introduction

Most of the studies on liability of foreignness have focused on developed countries, but with the increasingly globalized market and the rise of new economies like India, China, Mexico, Indonesia and so on, it is worth and necessary to focus on the costs of doing business abroad also in these emerging markets. Companies from both developed and developing countries are nowadays investing more and more in emerging economies, either as part of a global supply chain or as final consumer markets, given the growing middle class that characterizes these countries. The main difference of operating in emerging markets compared to industrialized ones is the transitional nature of their industrial and institutional environments, which brings enormous opportunities for foreign firms but also high instability and operational uncertainty (Luo et Al. 2002). We will first analyze the market conditions of emerging economies to understand why are they so different and how to deal with liability of foreignness in these situations. We will later focus on China, its peculiar characteristics and the most common strategies adopted by foreign companies in the market.

Transitioning economies: an overview of market conditions

Transforming economies are characterized by highly volatile, uncertain and changing institutional environment (Yildiz & Fey, 2012): under these circumstances, liability of foreignness is amplified, due to both an unpredictable institutional framework and a structural industrial uncertainty, which makes very difficult to control external environment.

According to Peng et Al. (2008) many studies on developed economies take institutional framework as a background and maintain that it’s not among the main factors influencing firms’ strategy. From another perspective, when markets work smoothly in developed economies, the market-supporting institutions are almost invisible (McMillan, 2007). But when markets work poorly like in emerging economies the lack of strong institutions, either because they are in a transition phase, either because they are still underdeveloped, has a very strong impact on both domestic and foreign companies and they must take it into consideration when formulating their strategy. A good example is the study from Makino et Al. (2004) where they show how performance of subsidiaries of foreign companies in emerging countries are influenced more from country-specific factors – proxies for institutional differences - in contrast with subsidiaries in developed countries, whose performance is more related to firm-specific effects.

In transforming economies it’s very important to evaluate carefully the institutional background, because when the *rules of the game* (North, 1990) are subject to high variability, is difficult to choose the best strategy to adopt. As Peng et Al. (2008) put it, the key question for both local and foreign companies is: “how to play the game when the rules of the game are changing and not completely known?” (p.924).

Alternative point of view - Transitioning economies and lower LOF

As opposed to the aforementioned authors, according to who foreign companies face a higher level of liability of foreignness in developing countries due to increased uncertainty, others maintain that the transitioning nature of these markets doesn’t necessarily increase LOF.

According to this alternative view transforming economies like those of emerging markets do not always have a negative effect on liability of foreignness. In fact multinational enterprises might face lower pressure by underdeveloped or changing institutions, as often is the case of developing economies. For example Kostova and Zaheer (1999) argue that foreign subsidiaries may benefit from their foreignness when a political, economic or social upheaval is going on in the host country. The same authors also maintain that foreign companies have an advantage where stakeholders in the institutional environment has a “long-standing sense of inferiority and xenophilia” (Kostova & Zaheer, 1999).

Perez-Batres and Eden (2008) maintain instead that transitioning institutions not only affect foreign investments, but also local businesses, and define *liability of localness* the set of added costs faced by domestic players during periods of uncertain market environment. According to them regulatory changes give opportunities to foreign investments by changing the rules of the game (North, 1990) to which local players are used to. Jiang and Stening (2013) go even further, saying that liability of localness persists after the institutional turmoil is over in those markets where foreign companies still have a solid competitive advantage over domestic firms, and this is particularly true in developing countries.

Dealing with stakeholders in transforming economies

A country’s institutional structure is impersonalized by the main groups of stakeholders who put pressure on all the companies and influence their strategies. According to Yildiz and Fey

(2012) transforming economies are characterized by three aspects that influence not only firms' strategy but also the way stakeholders affect it: first, these economies are by definition undergoing more or less rapid transformations where old institutions are substituted by new ones. Second, these changes are likely to result in contemporary existence of old and new norms, increasing uncertainty and volatility, but also giving several market opportunities to new entrants. Third, emerging countries are most of the times weaker economies compared to developed countries, where usually FDI come from, and this can give to local consumers a better perception of foreign brands.

Given the aforementioned characteristics Yildiz and Fey (2012) argue that foreign enterprises can sometimes find ways to reduce institutional pressure for homogeneity and pursue their goals without necessarily foregoing legitimacy, therefore avoiding those strategies that are aimed to better adapt to the local environment. Also Nachum (2003) argued that the firm performance in a foreign market the result of the combined effect of pressure from local institutions and the advantages of being an MNE. In particular it's possible to address four groups of stakeholders that are commonly thought to put pressure on foreign companies – suppliers, customers, employees and government (Di Maggio & Powell, 1983) – in order to reduce or ignore this pressure.

Relationship with suppliers is vital in order to secure the acquisition of critical resources at more favorable terms (Deepouse, 1999), and sometimes even to just acquire scarcely available resources. This would normally entail strong ties with domestic suppliers and therefore a higher demand for adaptation and legitimacy. In emerging economies risks associated with local procurement are higher, hence companies that can rely on a wider global or international supply network tend to curb their dependence on domestic suppliers getting more resources from there (Luo, 2003). Therefore ensuring the acceptance and support of local supplier may not always be a major concern (Yildiz & Fey, 2012).

In standard conditions foreign companies are forced to adapt their marketing mix in order to appeal to cultural values and expectations of local customers, especially in those countries where consumers are ethnocentric and have positive bias towards domestic products (Klein, 2002). This is not always true though in developing countries where, as mentioned before, often foreign brands are perceived as of better quality or value. This positive consumer bias in transforming economies is defined as "consumer amity" by (Baughn & Yaprak, 1993). Moreover the institutional change often bring with himself a shift in values and tastes, as shown by Wan (1998) in his study on China, where economic reforms have brought massive changes in economic development and institutional transformations, and the impact on lifestyle and consumer behavior and preferences has been incredible. These changes can sometimes reduce the need for adaptation of products and services by foreign companies or could even make it counter-productive: in these cases foreign companies would face less pressure to local isomorphism.

Hiring local employees in a foreign country is a critical process in order to successfully implement organizational practices, especially when establishing a new venture in a country with a high degree of cultural distance (Hofstede, 1980); often the foreign company is forced to adapt its practices in order to fit with local culture and avoid internal conflict. When hiring in emerging economies, Yildiz and Fey (2012) say, foreign companies have a better chance to find employees with values compatible with the firm's one due to the transitional status of the environment. The ongoing institutional transformation in these countries brings higher level of diversity of cultural values among different social groups in terms of education, interests and orientations. Cultural and social differences in a given country allows foreign companies to import their organizational practices and reduces the need of local adaptation if they focus their hiring effort on employees who can better fit these practices (Yildiz and Fey, 2012).

We have already mentioned that often local government and formal institutions can harass foreign companies, targeting them with laws and other instruments in order to protect domestic firms and national interest in general. For emerging market though FDIs are often the most effective way to realize sustainable growth and it's common for government of these countries to incentivize foreign companies to set up subsidiaries within their border, either with tax incentives or with infrastructure support. The relationship between governments and foreign companies therefore do not always end up with increased LOF, since the net effects of foreignness depend on the interaction between the two parties (Henisz & Zelner, 2005).

Table 2 below summarize the two point of view: 1) the more traditional institutional view according to which companies will adapt to local environment under the pressure of institutions, in order to increase their legitimacy with stakeholders; 2) the other alternative view from Yildiz and Fey (2012), according to which foreign enterprises are not always forced to adapt in transitioning markets because of the particular conditions affecting these markets.

Table 2 – Characteristics of stakeholders in transforming economies.

Stakeholder	Traditional view	Alternative view
Suppliers	Implement strong connections with local suppliers in order to increase legitimacy and improve sourcing capabilities	Global or international supply network to curb dependence on domestic suppliers.
Customers	Adapt marketing mix to local tastes and culture.	*Consumer amity*: foreign brand are perceived as better than local in developing countries.
Employees	Hiring and retaining employees in culturally distant countries often present a trade-off between maintaining organizational practices and avoid internal conflict.	The value shift often ongoing in transforming economies may influence locals' values and culture to adapt to foreign companies' organizational culture.
Government	Protectionism by mean of tariff and non-tariff barriers.	Government in developing countries tend to incentivize FDI to boost economic growth.

Adapted from: Yildiz and Fey (2012)

All the aforementioned situations of course are not valid in every developing country, and the listed strategies are not available for all companies operating in a foreign market. In fact Yildiz and Fey (2012) when describing these alternative strategies mostly refer to MNEs. This does not mean that smaller firms can never adopt these strategies, but it's clear that it would be more difficult, and sometimes even impossible for companies lacking the resources or the recognition available for multinational enterprises. A host government for example is more likely to give incentives to big companies that can bring a significant rise of employment level and heavy investments rather than to SMEs that can hardly guarantee the same results.

Moreover, as already mentioned, these situations cannot apply to every developing economy in the same way. Emerging economies are indeed characterized by common factors, but are also different between each other and therefore present unique market conditions. I have focused in particular on China, which has a very complex and dynamic business environment and offer a rich context to analyze liability of foreignness (Luo et Al., 2002). In the next section I will go through its peculiar characteristics and later on I will describe what the main strategies according to the relevant literature are.

China: a unique country

China has seen an unprecedented economic growth in the last thirty years that brought the country to be the second economy in the world, second only to the United States. This nonetheless doesn't make its business environment comparable to other mature markets in developed countries, those considered as *first world countries*. The Cambridge Dictionary defines a developed country as "a country with a lot of industrial activity and where people generally have high incomes" (dictionary.cambridge.org), and commonly are included in this category countries with high Income per-capita and a preponderant proportion of tertiary sector in their economy.

China in fact, a huge and diverse market, is characterized by extremely different regions, from the most advanced and economically developed cities on the eastern coast to remote villages of central and western China, and is still therefore somewhere in the middle between the status of developing and developed country. Moreover the country has been mostly rural until recent years and despite the economic boom brought its economic performance to the top of the world the institutions couldn't quite keep the pace and are not fully developed as you would expect in a developed country.

Market overview

Even though Chinese economy is the second most powerful of the world in terms of GDP, it cannot be considered a developed economy. Indeed by the most commonly used to criteria used to considered a country as developed (e.g. GDP per-capita, level of industrialization and more recently the Human Development Index), China cannot be included in this restricted *club*. These criteria though do not show the full picture. China for some aspects, especially in the most developed regions, has levels of technological adoption (for example the market penetration of smartphones or internet) comparable, if not superior, to more developed countries.

What really makes the difference are the institutions that as already mentioned could not really keep up with the pace of economic development and are still, also in major cities, in a transitioning stage. Transitioning institutions means of course high uncertainty and volatility, which together with non-transparent government policies and a peculiar business culture (Luo et Al., 2002) make the market a very complex one, where LOF is commonly considered to be higher than in other emerging markets. Considering that until the beginning of economic reforms and the opening to the world under Deng Xiaoping ruling from 1978 China's institutions were virtually non-existent, together with commercial laws and their enforcement (Ahlstrom et Al., 2003), it's no surprise that an efficient legal structure has not been implemented yet. Moreover the continuous overlapping of local and national laws and regulations and the inconsistency of their application has definitely not helped to speed up the process.

Someone could wonder how the Chinese economic *miracle* was possible in such a uncertain and poorly regulated business environment. Peng (2005) suggests that when formal institutions are missing, informal institutions, such as norms and conventions, will compensate for the lack of them. In china for example private companies have been legalized only after the economic reforms began, and they have been politically less favored than SOE: this pushed them to adopt carefully legitimacy building strategies (Ahlstrom et al., 2008). Ahlstrom includes among these strategies seeking financial resources that can be safeguarded from government interferences and creating connections with influential actors that can guarantee legitimacy and protection. Also Peng et Al. (2008) maintain that the large influence of personal relationships - *Guanxi* in Chinese – on companies' strategy is an effect of the lack of formal institutions, even though other authors suggest that this characteristic is a peculiarity of Chinese culture (Redding, 1990).

What Guanxi is and how it works

Guanxi is indeed deeply embedded in the Chinese culture and society that have been functioning within clan-like network ever since Confucius codified societal rules, values, and hierarchical structures of authority during the sixth century B.C. (Luo et Al.,2008), and only recently has been opened to western style business laws. Guanxi therefore is still permeating every aspect of the society, influencing both private life and business.

But what is actually Guanxi in Chinese? The word is in most dictionaries translated in English as "connections, relations, or relationships", but this definition can't really convey the full meaning of the term. Wong et Al. (2003) explain the etymology of the term: the character *Guan* (关) means in this case "door lock", and the character *Xi* (系) means instead "system of links”. Therefore the Guanxi can be understood according to Fernandez and Underwood (2005) as “a connection between two parties through a links when one party chooses to *open one link* to the other party” (p. 2). In other words, Guanxi can be considered a network of connections and relationships that can serve as social currency, granting access to information, opportunities, resources (Tsui et Al. 2000). Especially in a business context, it contains implicit mutual obligations, assurances and understanding, and it is the foundation of long-term relationships in the Chinese society (Luo et Al., 2002): according to Wang (2007) Guanxi is personal, reciprocal, and utilitarian. In this kind of relationships the two parties should always respect a set of unspoken rules of reciprocity and equity and violation of these rules can bring to the loss of “face”, or *Mian* (面), a loss of prestige and legitimacy not only with the other party involved, but within the whole network. It’s important to notice that Guanxi is not exploitation or manipulation, because all those involved are well aware of the rules of reciprocity and that the exchange of favors is fundamental to maintain the relationship.

Even though Guanxi is always built between individuals, interpersonal connections always transform to inter-organizational connections in the Chinese society and thus become a valuable resource to overcome liability of foreignness. In fact unlike Western society, where inter-organizational connections come first and inter-personal connections will follow if the former cooperation is successful, in China interpersonal relations are a prerequisite to inter-organizational interlocks (Luo, 2000). Thanks to strong relationships among key managers in the organizations involved, Guanxi then can be utilized as an asset at the organizational level to improve the relationship and reduce pressure from external shareholders. The personal nature of Guanxi has an evident drawback though. Since the relationship resides in the individual manager himself, in the case the manager decides to leave he takes all his business Guanxi with him, the more the manager was a high level one, the bigger the loss in term of relational assets for the firm (Fernandez & Underwood, 2005). In china hiring or retaining somebody is not only about his skills and capabilities.

Not understanding how Guanxi works then can seriously hinder a company’s performance in the country. It is in fact so pervasive that foreign enterprises are, or will be, certainly affected directly or indirectly by its effect on social and business dynamics. Only understanding it though often is not enough: a foreign firm who can not only understand how Guanxi works, but also how to use it can effectively on one hand increase cultural adaptation, and on the other hand reduce institutional uncertainty (Luo et Al., 2002).

Corruption, red tape and uncertainty

The existence of Guanxi, and the exchange of favors that is part of its mechanisms, has also a drawback. The other side of the coin is that corruption can thrive in an environment where *favors* are not only largely common, but also socially accepted and incentivized. In other words, Guanxi even if not necessarily an origin or source of corruption, it's a facilitator (Luo, 2008). According to the same author Guanxi and corruption are becoming more and more intertwined, and he expects that they could eventually be undistinguishable from each other becoming a threat to the social and economic reforms occurred in the last three decades. Even those companies who play fair - hopefully the majority - are affected by corruption in two ways: 1) directly when officers in various government branches explicitly ask for favors (e.g. gifts, money) in order to do something that they are supposed to do or 2) indirectly when officers impede or slow down the regular procedure to favor somebody else. Foreign enterprises should be aware that corruption is widely common and they could find themselves affected, and therefore be prepared to deal with it.

Nonetheless Guanxi is not the only thing that let corruption flourish: also the highly bureaucratic nature of public offices is a fertile soil for it. In fact red tape in china is one of the biggest issues and affect both local and foreign companies in their activities. The amount of paperwork and the timeline to apply for any kind of license, or just to be compliant from the accounting and tax point of view is unbelievable and often stunning for companies that face it for the first time. It's easy to understand how in such a rigid and heavily regulated business environment Guanxi – or corruption – is widely used to shorten timelines or unlock a specific situation.

Red tape though is only part of the problem. Chinese administrative structure indeed doesn't help in this sense. Regional and municipal governments have a certain degree of autonomy for both interpret and enforce national laws, without mentioning a number of local policy which are exclusivity of these institutional bodies (Rossi & Fasulo, 2016). In addition often the application of policies is de facto discretional, to the point that two officers in the same government department, in the same city and even in the same office can ask for a different set of documents for the same procedure. The consequent uncertainty may result in additional delays in the already slow bureaucratic machine.

Chinese protectionism

Chinese economy is still nowadays affected by its planned economy heritage and the market, even though part of the WTO and open to foreign investments, is not yet to be considered a fully free economy. In fact China has completed officially his transition to open economy in 2007, fulfilling all the obligations required to be part of the World Trade Organization, but non-tariff barriers didn't decrease quite as consistently and have instead kept growing (Rossi & Fasulo, 2016). Many sectors are still not accessible to FDI, and others are available only under certain restrictions in term of ownership, forcing the creation of joint ventures. So even if foreign companies have been incentivized in several ways - sometimes specifically tailored incentives in case of big multinationals - to invest in the country in the past three decades, investors have never been guaranteed a full equality in terms of opportunities. And the picture is getting grimmer in recent years, with a reduction of incentives and the proliferation of stricter policies that have favored local enterprises. The disadvantages are even bigger compared to State-owned enterprises, that still make up a large portion of the economy and are of course advantaged when it comes to public auctions, subsidies, access to credit.

Protectionism doesn't manifest itself only in explicit laws, but also in the enforcement of labor and business laws that are supposed to be the same for every firm, local and foreign. Foreign companies are indeed much more controlled by the officials in the mentioned authorities than local firms: the result is that local companies manage to get away very easily if they are not compliant with law, because controls are looser or because authorities turn sometimes a blind eye. If this is a result of pressures from the central authorities or simply part of the public stigmatization mentioned by Vernon (1977) we can't know, but it is an actual issue.

HR management

As always when operating in a foreign market, companies have to deal with additional issues when hiring local employees. In general, as already mentioned, different culture and values make more complex to find employees who can fit in the organizational culture and thus companies need to choose between maintaining their corporate identity or increase the local adaptation (Bartlett & Ghoshal, 1989). Moreover in case a company hire a mix of local and expatriate employees the risk of misunderstandings is very high. This is even more true when the local culture is very peculiar and the market has only recently been opened to foreign investments, like in China.

According to Wu (2009) in China human resource management didn’t develop consistently with the economic growth and many foreign firms realized how different and complex is to hire and retain skilled labor force. First of all, decades of planned economy, where job security and career were not affected by performance, created a managerial class not motivated and committed, and the legacy of this culture is still recognizable nowadays. Foreign companies then find themselves in competition between each other and with domestic enterprises in order to hire experienced and motivated managers and employees.

Hiring is only one side of the coin. Once companies have found and hired suitable employees, and maybe invested time and money to train them, the real challenge is to retain them. China indeed has a staggering turnover rate which represents a source of high uncertainty for employers who are forced then to hire extra staff and have organizational slack. For example according to the website China Briefing (2015) in 2013, 35% of Chinese staff employed at international companies had changed jobs in the past two to four years, and 10.4% of employees had found a new job within the previous year.

There are several reasons behind this trend: first, the high demand for job on one side increases competition for the best employees and on the other side reduces risks of unemployment for those employees who quit. Second, due to the fast economic growth and consequent rise of wages, employees are likely to leave their company for a better paid job and this is also the main reason to leave according to Leininger (2004). Lastly Chinese cities are packed with internal migrants, workers from the countryside and rural provinces who moved to the more industrialized regions or cities for a few years in order to make a small fortune and later go back to their hometown to live a better life. These employees are not likely to commit to one specific company or the other, since their goal is not a lifelong employment, but the maximization of their revenues. Due to the recent economic slowdown, in major coastal cities the trend has slightly changed, because of lower demand, which makes quitting job riskier, and because of the evolution of economic structure in these cities, where less unskilled workers from rural areas are required, in favor of qualified workers. In second and third tier cities though, where GDP growth is higher than the national average, the problem is still a major concern.

Overcoming liability of foreignness in China

As previously described China has several peculiar characteristics adding up to the common issues usually encountered in transitioning economies. This particular environment is very complex for foreign enterprises that are likely to face higher levels of LOF compared to other countries (Luo et Al., 2002) and are forced to implement suitable strategies in order to overcome it and gain competitive advantage.

Institutional advantage

Li and Zhou (2010) suggest that an important role is played by the ability to secure scarce resources and gain institutional support from local government, which they define *institutional advantage*. This advantage nonetheless is not a direct driver of superior performance, but it leads to both differentiation and cost advantages, which are sources of competitive advantage and thus enhance superior performance. First, institutional advantage allows firms to seize critical resources more effectively, which in a situation of resource shortage can guarantee differentiation if competitors do not have access to those resources. Even in case resources are available to competitors, with institutional advantage a company can acquire them at a lower cost, which gives instead the firm a cost advantage. Second, in a country where the interpretation and enforcement of rules are subject to authorities' discretion (Luo, 2006), their support is determinant to conduct business more efficiently.

According to Li and Zhou (2010) the best method to achieve institutional advantage is the use of managerial ties, or what we have defined as Guanxi. As previously described Guanxi is a network of connections between individuals inside organizations that are based on mutual trust and sometimes even friendship and that include implicit obligation of assistance and exchange of favors. Building a good relationship with suppliers and clients – and stakeholders in general - is not the only way Guanxi helps to overcome LOF: on one hand in fact it is a very pervasive business practice in the country and foreign companies who can improve their network and implement its mechanics can reduce the cultural gap, increasing then its local adaptation and legitimacy. On the other hand Guanxi is a key factor to reduce the institutional uncertainty characterizing the market; it can be an instrument for companies to circumvent the slow Chinese bureaucracy and can give the chance to secure scarce resources or give an insight on precious information that are not commonly available. Luo (2006) for example maintain that local government's support is very important because the legal system is not reliable and subject to particularism and personal accommodation. Building up a good Guanxi network is as difficult as it's important for foreign companies. While local companies already have an established base of connections (e.g. relatives, friends, ex-colleagues, etc.) foreign enterprises cannot count on such thing and should therefore spend way more effort and resources to build a comparable network (Luo et Al., 2002).

Defensive and offensive strategies

Also according to Luo et Al. (2002) Guanxi network implementation is a key strategy used to overcome LOF in China, but differently from Li and Zhou's idea, it is not suitable to achieve cost advantages; Luo et Al. (2002) maintain indeed that another strategy widely used by foreign companies, contract protection, is more suitable to achieve them. The two strategies are diametrically opposed in the general framework of offensive and defensive mechanisms previously described in Chapter 2: in this view contract protection is a defensive strategy aimed to reduce uncertainty and safeguard company's rights against opportunism, Guanxi implementation is an offensive strategy used to improve local adaptation and proactively increase returns: it is indeed considered the most powerful proactive mechanism in China by Peng & Luo (2000). Their findings show that both contracts and Guanxi help foreign enterprises reducing LOF, the firsts by decreasing production and marketing costs – cost advantages -, the second by enhancing sales revenues - differentiation.

Even though China still lacks a well-established legal systems which can properly enforce laws and regulations and local player do not always consider signed contracts binding, giving instead priority to Guanxi connections, with the growth and internationalization of Chinese companies, contracts are playing an increasingly important role in the business environment, especially when dealing with foreign companies. Many Chinese firms realize indeed that traditional business practices cannot be applied in relationships with companies from other countries that do not understand them (Luo et Al., 2002). Moreover as explained by Li and Sheng (2011) the significance of connection diminish with the growth and ageing of the firm, that should instead develop more market-based capabilities and implement market-oriented strategies.

It's important to notice in fact that sometimes Guanxi can hinder firm performance if the company have too tight connections: managerial ties can be detrimental in a situation of demand uncertainty or technological turbulence, since the company could find itself stuck with existing connections and might not be able to adapt quickly to changing market requirements. Moreover as mentioned above Guanxi utilization has a declining effect on profitability of older firms. Guanxi then is very useful in the beginning stage of a company's life or during the developing of new markets or opportunities, but it could lose in effectiveness with the age of companies and fail to help them in achieving further growth if new connections are not created. These ties should shift over time in order to avoid becoming "encumbered with stale advice, protection, information, and resources" (Li & Sheng, 2011. p.566). The significance of connection according to this view diminish with the growth and internationalization of the firm, that should develop more market-based capabilities and implement market-oriented strategies. Market orientation places the highest priority on the profitable creation and maintenance of superior customer value (Slater & Narver, 1995) and enables enterprises, by paying attention to target customers interests, watching competitors closely and coordinating its functional units better, to effectively understand and timely respond to market changes, which is in a country like China a key factor to overcome liability of foreignness.

Nonetheless even the most modern Chinese firms are influenced, and they will probably always be, by Chinese culture and for instance they will never consider a contract enough to sustain a long-term relationship: they will likely perceive it as a way to safeguard each party's rights during a short-term relationship or one-off transaction. A client will come back and place more orders not because of a previous contract, but because a good relationship is in place, ceteris paribus. Contract protection is thus a useful method to overcome LOF reducing costs related to uncertainty and opportunism, but not a way to increase revenues, like Guanxi instead is.

Therefore, even though with the modernization of China managerial ties are partially losing their predominance in business transactions in favor of more market-oriented mechanisms, Guanxi will remain a very important component of the business environment in the country and a powerful instrument to reduce and overcome liability of foreignness. Companies do not face a trade-off between the use market orientation and the implementation of managerial ties – or in other words defensive and offensive strategies -, because the two mechanisms do not preclude each other, and are in fact complementary (Luo et Al. 2002): according to their finding firms who implement both have on average better performance than those who implement only one, regardless their choice.

Adapting strategies and practices to the Chinese market

A recent research by Rossi and Fasulo (2016) suggest that foreign companies shall adopt a focused set of strategies to operate in the Chinese market, and shouldn't stick to standardized organizational practices that might be suitable in other countries. Too often Chinese subsidiaries and their managers are not given the strategic weight they deserve; consequently in these cases they are not represented in the top management and they are not part of strategic decision making process. Moreover their findings confirm that a pre-entry learning engagement (Petersen & Pedersen, 2002) might be a useful method to reduce liability of foreignness when a firm eventually enter the market.

Despite pre-entry learning engagement, and consistently with Denk et Al. (2012) who maintain that FDI are the only way to tap untouched sources of knowledge, foreign companies will be disadvantaged in comparison with domestic ones and should adopt focused strategies to overcome LOF. Among those mentioned by Rossi and Fasulo (2016) there are the appointment of experienced and skilled managers, differentiation, "becoming Chinese" (p.46) or targeting high-end niches, responsiveness to a changing market.

As mentioned before hiring and retaining skilled employees is a serious issue in China, and it's even more complicated when it comes to managers. Many foreign companies have struggled to build up a solid and stable management team in their Chinese subsidiaries, which often include many expatriates who are not willing to stay in China more than a few years. These foreign managers moreover often are not even senior employees in the organization, or they don't have a deep knowledge of Chinese market. This highlights the low attention that sometimes is payed to Chinese operations, that should instead be a main concern for the company. In general according to Rossi and Fasulo (2016) would be ideal to appoint somebody with previous experience in both the market and the industry, and if not possible at least provide an appropriate training to those who will be appointed. The advantage of hiring managers with *Chinese* experience is not only in the strategic knowledge they can bring within the company, but also their soft skills in managing employees. The research conducted by Fernandez and Underwood (2005) clearly shows that qualities like patience and humility are important when it comes to deal with local employees, and that applying an aggressive western managerial style can be detrimental and has less success than a humbler approach. Moreover companies shouldn't exclude the possibility to hire local employees as top managers of Chinese operations: this strategy could have some drawbacks in term of organizational culture, but would greatly increase the adaptation to local environment, without forgetting the Guanxi baggage that these employees could bring into the organization.

Starting from the idea that foreign companies need to adapt their strategy to the Chinese market, depending on their size and financials Rossi and Fasulo (2016) propose two choices. According to them a suitable way to compete with domestic companies is meet them in operational efficiency, reducing production and logistic costs and thus reducing the cost disadvantage. To do so foreign enterprises shall consider setting up their plants in central regions where labor costs are lower, restructuring operations and outsourcing, increasing the level of automation of their processes. Of course these strategies assume a economies of scale and significant investments. Anyway it's important to notice that even if the subsidiary can achieve its goals of efficiency, a strategy based only on cost advantages cannot, by itself, achieve competitive advantage in the short term and is not sustainable in the long term, especially in China.

This is why foreign companies should always have a certain degree of differentiation in terms of brand, quality, value proposition or innovation. Companies that cannot afford or are not interested in huge investments in the country have an alternative choice: to focus on high-end or niche markets, less subject to local competition since target costumers value more quality and brand differentiation. In any case success is not granted even in this sector, given that this is the main market for imported goods in the country and Chinese consumers are still very influenced by the biggest brands. Intensive marketing activity and the right positioning are key factors of success in these cases.

Considering the recent economic slowdown, the major reforms that are being implemented by the central government in these years and the evolving customer taste, according to Rossi and Fasulo (2016) foreign companies should also be able to cope with the fast evolving Chinese business environment. According to Fernandez and Underwood (2005) companies can be sure that in every moment there will be some aspects of their business changing. Market orientation (Li & Sheng, 2010) allows firms to "respond to market intelligence in a timely and efficient manner and deliver superior value to meet the unique needs of its market"(p.858). For instance the staggering growth of e-commerce in China is definitely something that companies have to take into account to re-think their distribution strategies accordingly. This need for agility could clash with the use of Guanxi networks, which could in some cases, as stated by Li & Sheng (2010), affect the ability of the firm to quickly respond to market changes.

All the strategies analyzed in the last section have their advantages and drawbacks and no one in particular can guarantee the achievement of competitive advantage. China is a very complex market and every company should find its own recipe. Table 3 shows a summary of the discussed strategies, with their most relevant PROs and CONs

Table 3 – strategies to overcome LOF in China, PROs and CONs.

Strategy	**PROs**	**CONs**
Guanxi – Managerial Ties	Proactive mechanism. Increases sales; reduces cultural gap and institutional uncertainty, enhances legitimacy; gives insight on exclusive information.	Requires time and effort to implement. Could negative affect the ability of the company to quickly react to market changes. Can be less effective for older/bigger companies
Market orientation	Enables enterprises to effectively understand and timely respond to market changes.	Sometimes not compatible with Guanxi networks.
Contract protection	Defensive mechanism. Safeguards the firm’s interest in business transactions and reduces related uncertainty. Gives cost advantages.	Sometimes not effective in China because of the lack of institutional enforcement. Do not improve relationship with clients/suppliers.
Hiring managers with “Chinese” experience	Market knowledge. Improves adaptation and reduces cultural gap. Soft skills in managing local employees. Existing managerial ties.	Difficult to hire and retain, thus expensive. Risk of loss of corporate culture due to excessive adaptation of organizational practices.
Operational efficiency	Reduces cost disadvantage thanks to economies of scale and optimization of processes.	Very expensive. Requires intensive investments and effort.
Target high-end / niche markets	Less competition from domestic players; less price competition.	Many foreign brands in the market. Requires investments in marketing and the right positioning.

Conclusion

We have seen that developing economies are characterized by peculiar traits that affect heavily the behavior of foreign firms and likely increase the liability of foreignness – even though some authors disagree with this statement. China in particular, as noticed by Luo et Al. (2002), presents a very complex environment for foreign companies which should pledge enough resources first to understand it, and of course to implement suitable strategies to cope with LOF. The list of problems encountered by foreign companies is very wide and can vary from company to company, as well as the strategies adopted. The aim of my research is to empirically assess what are the most problematic and frequent difficulties faced by foreign companies in China, how they are related to their particular situation and subsequently to understand what are the most adopted and effective strategies implemented to overcome the liability of foreignness deriving from them.

Chapter 4: Empirical Analysis

Introduction

We discussed in the previous chapters what is liability of foreignness and what are, according to the main literature, its drivers and its features. We also discussed the fact that LOF is different in developing or transitioning economies compared to developed markets, and that China in particular has some peculiar characteristics that make operating in the country very complex for foreign firms. I focused my research on this market because of its relevance in nowadays global economy and because I believe that despite studies have already been focused on it, the dynamics of the business environment are still unclear to many.

The purpose of my research is to analyze what are, according to foreign firms' managers experience, the main drivers of liability of foreignness here in China and how they are related to company characteristics. Data collection was conducted using a questionnaire which can be seen in annex 1, sent to foreign managers working in china or in charge of Chinese operations. The questionnaire was sent in August 2016 to 57 managers, and the response rate was 39%: 22 filled questionnaire were collected. Due to the modest size of the sample, and the fact that all the companies in it are based in Shanghai, my findings are not definitive or descriptive of the whole Chinese market and shall be seen only as interesting insight into the complex business world of the country.

Sample analysis

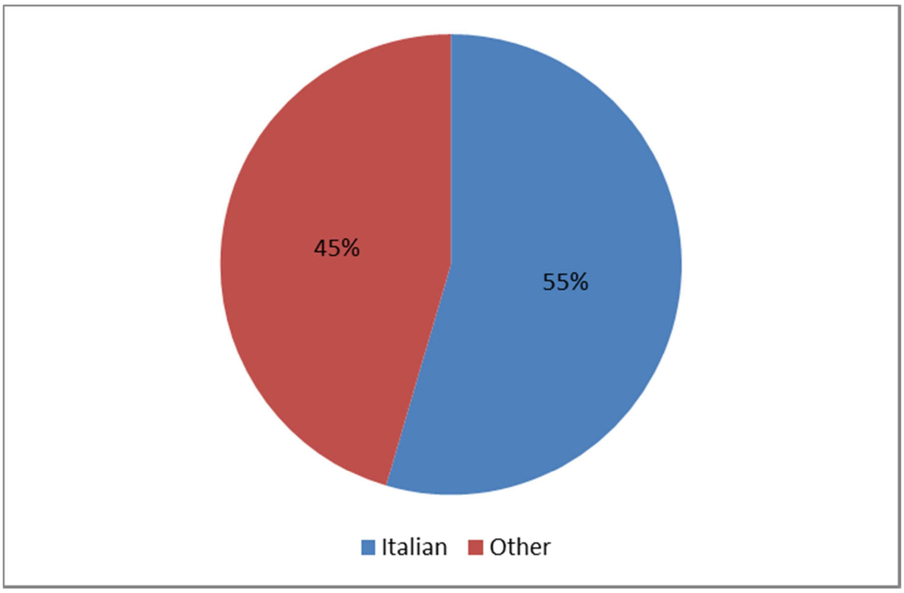
As mentioned above the sample has been collected among companies based in Shanghai, the respondents are either living in the city either going there periodically to follow the business, thus they all have first-hand experience in the market. They all are of course foreigners and therefore their experience is valuable for the purpose of this research. Moreover, the sample is variegated, including companies from several countries and operating in different industries. The internationalization level of the foreign enterprise or group controlling the Chinese entity also vary from small companies at the beginning of their international expansion to bigger corporations with several subsidiaries in the world, even though the majority are SMEs. The size of the subsidiary itself changes among the sample, as the type of legal entity chosen. Lastly, most of the subsidiaries have been set-up in recent years, and no one in the sample has been established earlier than 15 years ago.the number of companies in the sample is 22.

Country

The sample includes companies from different countries, even though more than 50% is from Italy. Of the 22 firms in fact, 12 are Italians. The remaining companies are from European countries like France (1), UK (3) and Germany (2) and from the USA (1) or Hong Kong (3). I considered foreign companies also those from HK for two reasons: the first is that the three companies in the sample were all founded by foreign individuals, so even if the legal entities might not be considered completely foreign in China, the individuals running them definitely are. The second reason is that the city-state, only recently part of the People's Republic of China, has still a lot of autonomy, especially when it comes to business environment, with well-established institutions and an efficient juridical system.

In order to run the analysis I coded the sample in 2 groups according to the country of origin: since the majority of firms is from Italy, the first group includes all these companies. The other countries are not represented by a sufficient number of companies to have each one a group on its own, so they have been included in a residual group as shown in figure 7 below. The two groups formed make up respectively the 55% (Italian) and 45% (Other) of the sample.

Figure 7 – Composition of the sample | Country of origin



Industry

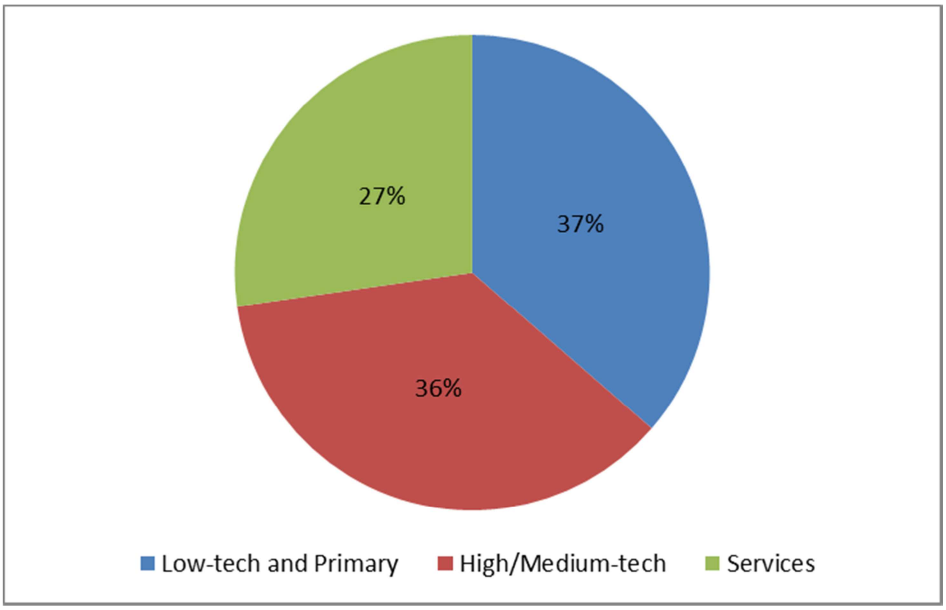
As mentioned before there is a big variety in terms of industry in the sample, with as many as 15 industries represented, listed below in table 4.

Table 4 – Composition of the sample | Industry

Industry	**N of companies**
Pharmaceuticals	1
Electronics and computing machines	1
Electrical machinery and machine tools	1
Automotive and transportation equipment	1
Mechanics	2
Chemicals (no Pharmaceuticals)	1
Rubber and plastic products	1
Mineral products, petroleum products and basic metals	1
Textile and apparel	2
Home Furniture	3
Agriculture	1
Food and Beverages	1
Retail, distribution and Logistics	1
Architecture and Design	1
Business and Financial Services	1
Financial services	1
Health Care	1
Insurance and Bank	1

Also in this case, in order to run my analysis, I had to split them in 3 groups that can supposedly share similar levels of liability of foreignness and same market conditions: High-tech and Medium-tech industry, Low-tech industry, where I included also a couple of firms operating in the Primary sector, and Services. The sample in this case is quite evenly distributed in the three sectors, as highlighted in figure 8 below: firms working in the service industry are the 27% of the sample, while the other two groups equally include 36.5% of the sample.

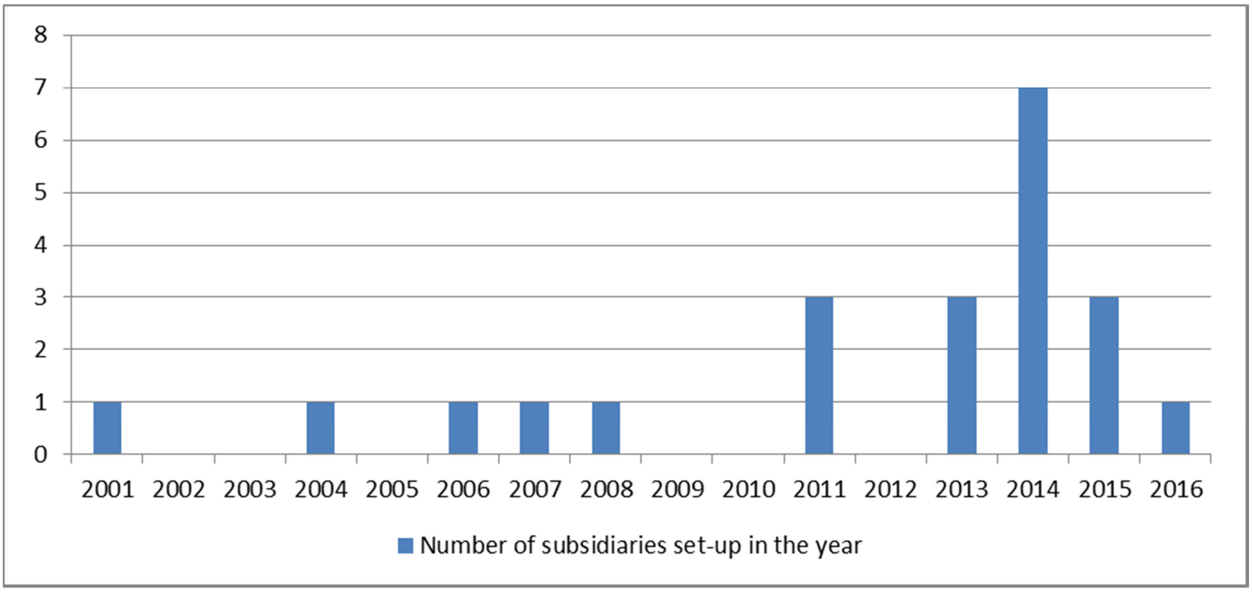
Figure 8 – Composition of the sample | Industry



Year of establishment

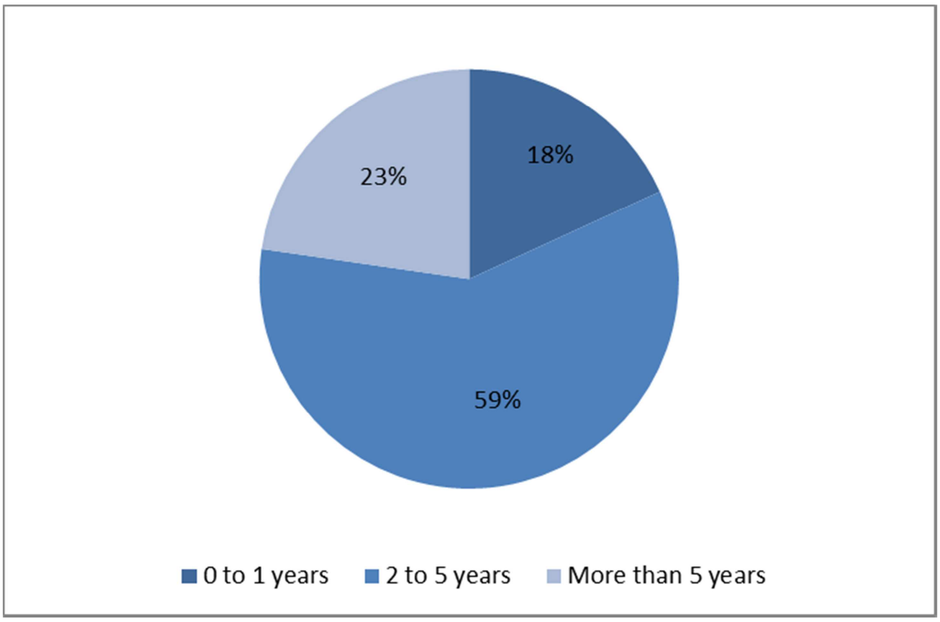
Another indicator of the level of internationalization, but specifically in China, is the year of establishment of the subsidiary in China (the first one in case there are more), or what we can define *Age* of the subsidiary. Also in this case the sample is not evenly distributed in the interval and more than ¾ of the subsidiaries have been set-up not earlier than 2011. The oldest subsidiary was established in 2001. Figure 9 below shows the distribution of ages in the sample.

Figure 9 – Composition of the sample | Number of firms per year of establishment



In order to highlight the different stages of their life in China, I split the sample in 3 age-based groups: 0 to 1 years; 2 to 5 years; more than 5 years. Figure 10 below shows how the sample is distributed in the three groups.

Figure 10 - Composition of sample | Age

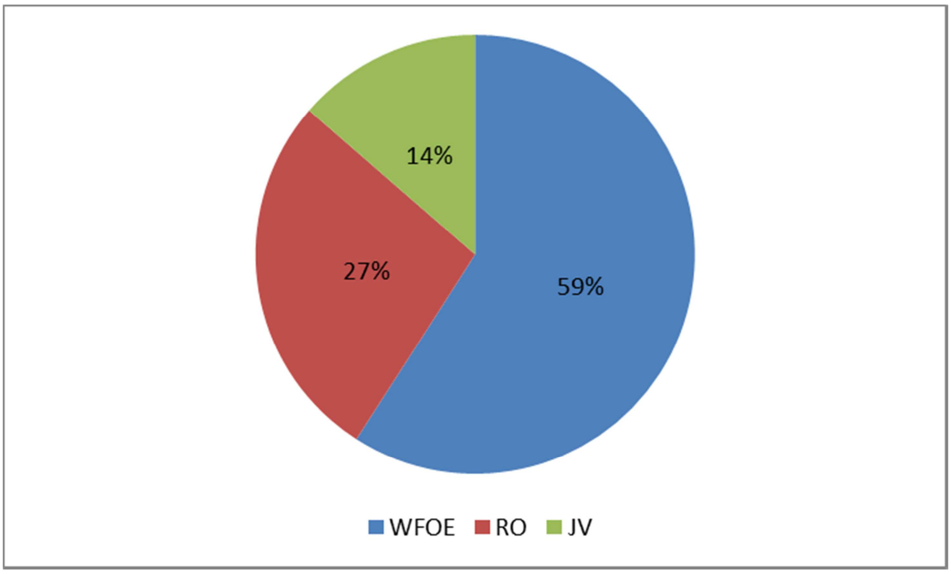


Legal entity

There are different type of legal entity that can be chosen by foreign investors when setting up a company in China, the most common is the Wholly Foreign-Owned Enterprise (WFOE), which is a limited company and is, as the name itself says, owned by foreign companies or individuals. In case one or more of the shareholders – but not all of them – are Chinese firms or individuals the entity is defined as Joint Venture (JV). The third option available to foreign investors is the Representative Office (RO); the difference between a RO and the other two options is that it does not have full legal personality. The RO in fact can only carry on market research and PR activities, and cannot in any way directly sell or manufacture goods or provide services.

The sample includes all three of the entities, even though more than half of the companies are WFOEs. This is not surprising at all and probably reflects the real composition of the population. High flexibility and wide scope of use of the WFOE, without the burden of a local investor, make it the preferred choice for many foreign investors. In the sample we can find 13 WFOEs, 6 ROs and 3 JVs, as shown in figure 12.

Figure 11 – Composition of the sample | Legal Entity



Export to china before set-up

According to the internationalization theorist Johanson and Vahlne (1977), companies entering a spatially and culturally distant market usually try to first test the waters and only later establish a subsidiary in it. The sample can be divided into companies who have acted consistently with the theory and were exporting to China before actually setting up a subsidiary, and those who instead were not. The two groups are similar in terms of size, with 10 companies who used to export before and 12 who didn't.

Analysis of drivers

In order to understand what are the main issues faced by foreign companies in China a list of problems that I expected companies to be affect by - or in other words a set of drivers of liability of foreignness - was included in the questionnaire sent to companies. The list was adapted from the set of issues analyzed by Rossi and Fasulo (2016) and considers different aspects of Chinese business environment. Managers were asked to rate from 1 (irrelevant) to 5 (critical) every driver according to their experience. The full list of 13 drivers can be found in table 5 below. Data collected were then used as a proxy of LOF: the average rating of each driver serves as a proxy of the effect the driver has on foreign companies on average according to managers' experience, while the average driver score for each company stands for the LOF experienced overall by that firm in particular.

Table 5 – List of drivers of LOF submitted in the questionnaire

N°	**Drivers of Liability of Foreignness**
1.	Intellectual property rights infringement
2.	Chinese protectionism
3.	Geographical distance
4.	Language differences
5.	Cultural differences
6.	Discrimination against foreign brands/companies
7.	Bureaucracy and Licensing requirements
8.	Unclear regulations
9.	Corruption
10.	Difficulties in finding suitable local partners
11.	Work force not qualified
12.	Management-level human resources constraints
13.	Non-Management-level human resources constraints

IP rights are a recurrent topic when talking about business in China. The country in fact has a chronical problem of counterfeit and IP infringements and despite laws are in line with WTO requirements, institutions have not been able – or not been willing – to enforce them effectively. Moreover the Apple's case (BBC.com) previously mentioned shows how protectionism plays an important role also, but not only, in IP disputes. Protectionism manifests itself indeed with both tariff barriers as high import and custom duties, and non-tariff barriers e.g. restrictions to foreign investments in specified industries considered strategic, favoritism to domestic firms both for public auctions and in the courts, access to credit. The discrimination is not only institutional, but it might exist also in consumers behavior: although Chinese consumers appreciate and recognize the higher quality and value of foreign brands, the rise of renown local firms, together with the transition from quantity to quality in the industry sector, is changing public opinion on perceived value. It's also important to remark a growing sentiment of nationalism linked to several international disputes – the South China Sea is one example – which could aliment a negative bias towards foreign companies, especially western ones.

In fact the majority of participating companies are based in Europe or North America. For this reason I expected that also geographical distance, and derived complexity of coordination with the headquarter, is a potential issue and therefore should be considered. China is not only geographically far though, it is also characterized by a unique culture which is very different from the western one and that affects heavily also the business environment, as already described in chapter 3. The cultural distance translates also in the complexity of finding business partners: different business practices and often misunderstandings make finding a suitable partner in loco very problematic. In addition Chinese managers are reluctant to trust possible partners without before implementing a Guanxi relationship, hampering the chances for foreign managers to find a partner.

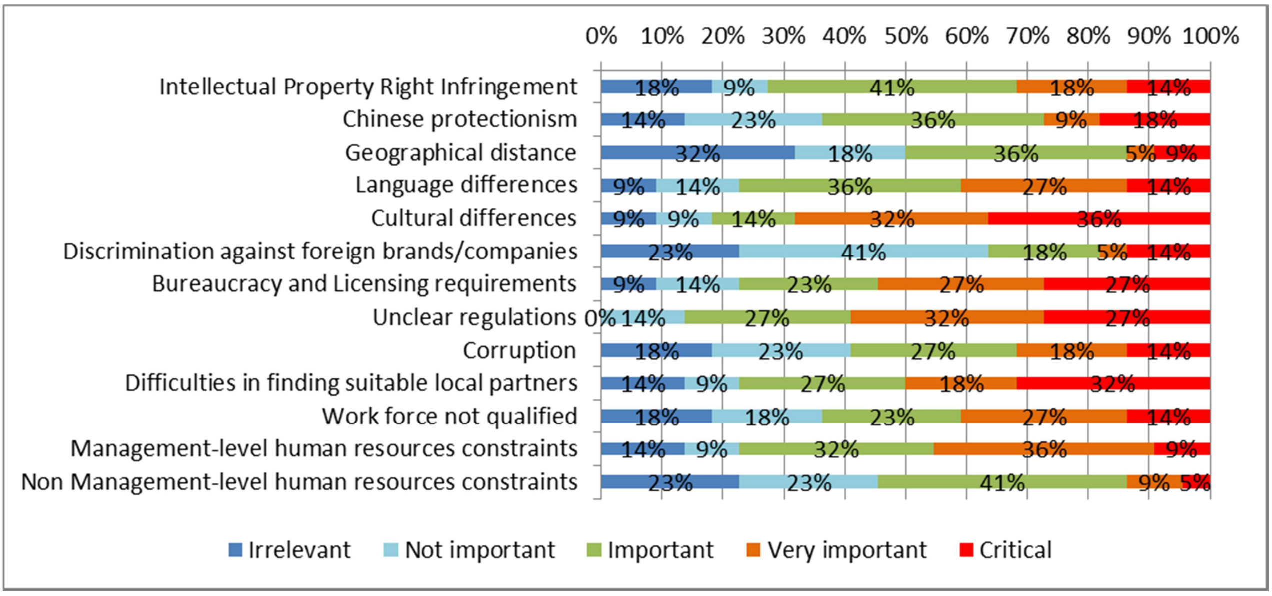
Along with the peculiar culture comes also a very different language: the language barrier issue is intensified by the fact that many locals do not speak English. This of course reflects not only on the relationship with external stakeholders, but also with internal ones. We have already mentioned the challenges of human resource management in China, which depend by both cultural and institutional factors (Bartlett & Ghoshal, 1989; Kostova & Zaheer, 1999). HR management has constraints for both managerial and non-managerial positions. For instance finding the right performance indicators and incentives for local managers, that sometimes are still influenced by the old planned economy mentality, is not as immediate as one could think, given the different expectations and goals from their western counterparts. This is valid of course for employees at every level, but somehow more concerning when it comes to people who can affect performance of the subsidiary with their decisions. One common issue for what concern non-management human resource constraints is for example the incredibly high turnover rate affecting several companies in every industry. Employees are in general not committed to the company they work for, that they see just as a temporary step in their career and are eager to leave for a small salary raise or different job title. The situation is even grayer when it comes to migrants from the rural provinces, who often leave without notice to move back to their home town. Moreover a big problem is hiring and retaining qualified employees, due to the strong competition not only with other foreign firms, but also with domestic firms who are increasingly more appealing for locals, thanks to the number of those with an international profile.

As in other developing economies red tape and institutional uncertainty are a main issue in China for the reasons we discussed previously in chapter 3, so I expect bureaucracy and unclear regulations to be a major concern for the respondents. These two hurdles are often somehow related to corruption through the bad use of Guanxi networks. Corruption issue is so common and widespread that the central government and communist party top officials have recently engaged in a nationwide anti-corruption campaign, sponsored by the Chinese president himself Xi Jinping.

Data analysis

Data collected show that the most concerning issue, rated by the 68% of respondents as very important or critical, is cultural difference. The same driver retains also the most rated position as critical. Four drivers in total are considered by 50% or more of the companies as at least very important, as shown in figure 13. Unclear regulations is the second most concerning problem behind cultural difference, with 59% of managers considering it very important or critical, and bureaucracy and licensing requirements comes right after with 54%. The fourth most relevant problem is finding suitable local partners, rated by 50% of the firms at least very important. On the other side, we can notice that among the least concerning issues are geographical distance and non-management-level HR constraints, both considered by only 14% of respondents very important or critical, and discrimination against foreign companies and brands (19%).

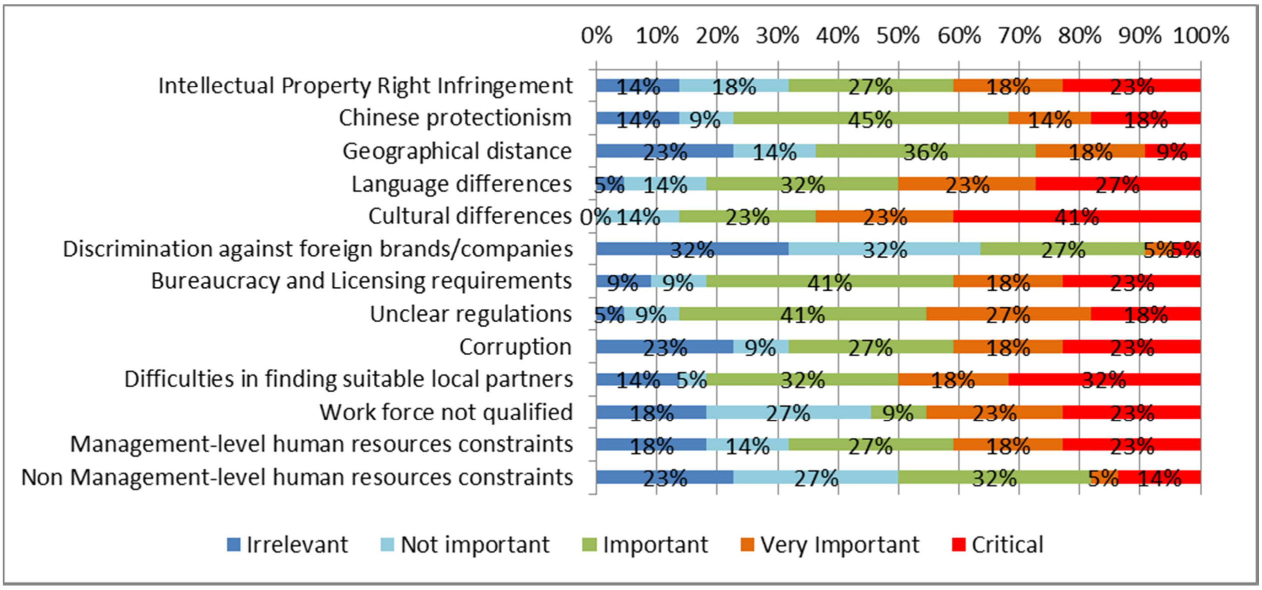
Figure 12 – Rating given by respondents to LOF drivers | % of total (2016)



It's worth to notice a few interesting points shown by the data. First of all it's no surprise that cultural difference takes the first spot as most problematic driver: Chinese culture permeates the business environment and every foreign company needs to get in touch with it. the way of doing business in the country is very different from what foreign firms are used to and even if they are willing to adapt their practices as suggested by Di Maggio and Powell (1983), sometimes they simply can't fully understand how to do it. It's unexpected instead that language difference, an issue you would imagine to have similar scores to cultural distance, is considered not as concerning. Though if we look at figure 14, where scores relative to the *time of first investment* in China are shown, we can notice that the same language difference driver is rated at least very important by 50% of the firms: these findings suggest that maybe the language barrier is a problem that can be at least partially overcome with time and effort. In contrast cultural difference driver appears to be a tougher challenge, since it was the most worrisome issue also at the beginning of firms experience, even though the number of respondents who rated it critical decreased.

Institutional uncertainty and bureaucracy, consistently with Luo et Al. (2002) that consider China among the most complex countries from this point of view, are among the highest rated problems nowadays. It appears instead that they were less relevant at the beginning, like if the proliferation and overlapping of laws or regulations, as well as the discretional nature of enforcement, got worse over time.

Figure 13 – Rating given by respondents to LOF drivers | % of total (time of first investment)



Another remarkable finding is that IP law infringements appears to be, surprisingly, not among the most concerning issues for companies in the sample, just 32% of them rate it as very important or critical, and at first look the perception of the issue is also improving in comparison with the beginning of their Chinese experience, when it was 41% of firms considering it very important. But if we check also the lower scores, we can notice that the number of companies not worried about it has also decreased, suggesting that probably companies are more aware of the issue, even though have found some way to mitigate it.

Also discrimination against foreign companies, the stigma that according to Vernon (1977) affects foreign firms, is not very relevant according to the managers interviewed; actually the high percentage (63%) of respondents who consider it irrelevant or not important might suggest the effect of a positive bias towards foreign brands, the so called “consumer amity” (Baughn & Yaprak, 1993). After all, it’s no news that Chinese consumers like foreign luxury brands, and this can be true also in sectors other than fashion. Comparing the data with those relative to the *time of first investment*, we can see how the number of companies considering it not important has not changed much and the issue is still one of the less concerning but we can notice one thing: among those companies worried about it, the relevance of the problem increased. The data could mean that discrimination might be getting worse, but only for a restricted group of companies.

Interesting is also the large gap between management and non-management level HR constraints: while the former is considered the fifth most worrisome driver, the latter is one of the least concerning according to respondents, and the answers stay quite consistent over time. This difference between the two drivers could have different meanings: for instance companies probably acknowledge the importance of securing key positions in order to achieve a good performance, and therefore perceive the issue more challenging than managing other employees. Another reason, partially connected to the one above, is the high demand for talented managers, and the increasing competition to hire and retain them. In fact non-qualified workforce is rated at least very important by no less than 40% of respondents, both now and at the time of first investment.

Now, if we look at the average score for every driver in table 6, we can see that our previous observations are confirmed from the sample average: the highest ratings are, in order, for cultural differences (3,77), unclear regulations (3,73), bureaucracy and licensing requirements (3,50) and difficulties in finding suitable local partners (3,45). In the table are included also average scores of data from the *time of first investment* ratings, in order to easily compare noticeable differences.

Probably due to its small size, the sample is characterized by high variance. In fact after a t-test on the average score for every driver for the two data sets (*2016* and *time of first investment*) shows that, with level of significance of 95%, the difference is not significant for any driver. Nonetheless, exactly because of the small size of our sample, it would be very hard to find some significant difference and therefore it's still worth to take a closer look to the average score of each driver in the two periods, and to its variance.

Table 6 – List of drivers of LOF | Average score and Variance

Driver of Liability of Foreignness	**Average score 2016**	**Variance 2016**	**Average score Then**	**Variance Then**
Cultural differences	3,77	1,71	3,91	1,23
Unclear regulations	3,73	1,06	3,45	1,12
Bureaucracy and Licensing requirements	3,50	1,69	3,36	1,48
Difficulties in finding suitable local partners	3,45	1,97	3,50	1,88
Language differences	3,23	1,33	3,55	1,40
Management-level human resources constraints	3,18	1,39	3,14	2,03
Intellectual Property Right Infringement	3,00	1,62	3,18	1,87
Work force not qualified	3,00	1,81	3,05	2,24
Chinese protectionism	2,95	1,66	3,14	1,55
Corruption	2,86	1,74	3,09	2,18
Non-Management-level human resources constraints	2,50	1,21	2,59	1,68
Discrimination against foreign brands/companies	2,45	1,69	2,18	1,20
Geographical distance	2,41	1,59	2,77	1,61
Average Driver	**3,08**	**0,37**	**3,15**	**0,53**

We can notice first of all that the average driver score (calculated as an average of each company's average driver) has slightly decreased from the *time of first investment* to *2016*. Despite the small difference and the subsequent lack of significance it looks like our proxy for liability of foreignness has slightly decreased over time.

As mentioned above, no significant difference has been found on the single drivers ratings, and the variance shown in table 6 highlight that very large differences would be required in order to be significant. The same variance though can be useful to understand more about the distribution of answers in the sample. Let's look for instance at the first driver in our list, cultural difference: the variance of answers relative to *time of first investment* is quite smaller, suggesting a larger concentration of high scores. The higher variance of *2016* answers shows a more even distribution of answers; in other words there's less agreement on how problematic the driver is, and more respondents rated it not important or irrelevant.

Another interesting point is that, although overall there has been a reduction in liability of foreignness perceived, 4 drivers are reported to be more concerning or effective on company results, according to respondents. The first 2 drivers are unclear regulations and bureaucracy and licensing: the increase also bring them on the second and third positions as most concerning issues, overcoming language difference and difficulties in finding suitable partners who are in those position, respectively, at *time of first investment*. The other two drivers are management-level HR constraints, whose increase is very small though, and discrimination against foreign companies, which is even after the increase the second least concerning problem.

Analysis of groups

In order to have further insight into the data, I analyzed the drivers rating splitting the sample in groups, according to the information collected that we saw at the beginning of this chapter. My goal is to understand what could be the variables related to drivers rating, or in other words how relevant are the drivers and how strong is liability of foreignness perceived by different population groups. Groups were created according to those information that could affect the driver strength: age, country, industry, legal entity and previous export activity to China. I will proceed now with the analysis of the sample divided according to the mentioned 5 variables.

Age of subsidiary

The age of the subsidiary – years since its set-up – can be a useful instrument of analysis for our sample. Moreover thanks to this division we could check the consistency of the sample data with the literature we discussed in previous chapters. Are those companies that operated for longer time in the country experiencing lower LOF, as maintained by Zaheer and

Mosakowski (1997) and Petersen & Pedersen (2002)? Are these companies improving in their efforts of mitigating LOF over time? The sample was split as described before in 3 age groups: 0 to 1 years (4 companies), 2 to 5 years (13 companies) and more than 5 years (5 companies). For every group a separate analysis was conducted and the results are shown in table 7 below. Next to each group name the number of firms in the group is shown.

Table 7 – List of drivers of LOF | Age groups analysis

Column	**1**		**2**		**3**	
Age groups	**0 -1 *(4)***		**2 – 5 *(13)***		**5 + *(5)***	
DRIVERS	**2016**	**then**	**2016**	**then**	**2016**	**then**
Intellectual Property Right Infringement	2,50	2,50	2,85	3,23	3,80	3,60
Chinese protectionism	2,25	2,50	2,85	2,92	3,80	4,20
Geographical distance	2,00	2,25	2,38	2,54	2,80	3,80
Language differences	2,75	3,00	3,38	3,46	3,20	4,20
Cultural differences	3,00	3,75	4,08	3,92	3,60	4,00
Discrimination against foreign brands/ companies	**1,75[3]**	1,75	**2,15[3]**	**1,92[3]**	**3,80[12]**	**3,20[2]**
Bureaucracy and Licensing requirements	**2,25[3]**	**2,25[3]**	3,69	3,46	**4,00[1]**	**4,00[1]**
Unclear regulations	**2,75[3]**	**2,50[3]**	3,69	3,46	**4,60[1]**	**4,20[1]**
Corruption	3,00	3,00	2,77	3,00	3,00	3,40
Difficulties in finding suitable local partners	3,00	3,25	3,38	3,38	4,00	4,00
Work force not qualified	2,75	2,75	3,08	2,77	3,00	4,00
Management-level human resources constraints	2,75	2,75	3,00	2,77	4,00	4,40
Non-Management-level human resources constraints	2,25	2,25	2,54	2,46	2,60	3,20
AVERAGE DRIVER	**2,54[23]**	**2,65[23]**	**3,07[13]**	**3,02[13]**	**3,55[12]**	**3,86[12]**

Legend: Drivers in **bold** present significant difference. Symbols next to numbers represent significant difference with data from the other period e.g. *then* (*), or the same set of data in column one ([1]), two ([2]) or three ([3]).

The first thing to be noticed is that there is a clear difference between the average driver of the three groups and LOF seems to increase along with the age of subsidiary, for both the *2016* and *time of first investment* data set: the older group in fact report the highest score in both cases, followed by the intermediate group. The youngest group present the lowest score in both cases as well. I have also run some t-tests on the differences between age groups and they all appears to be significant at 95% level of significance, with the exception of one which is instead significant at a 90% level. These finding are unexpected and not consistent with the most common literature that suggests instead that older firms should suffer less LOF.

The reasons behind these findings could be several: first of all according to Petersen and Pedersen (2002) time itself is not enough to bring knowledge to the firm. If the company put no effort in learning or if it is not open to change the longer time spent in the market wouldn't necessarily help to reduce LOF. Moreover we should consider the transitioning nature of the market, where frequent environmental changes could frustrate any experience gained. Another reason could be that companies who entered later in the market might have been already aware of many of the issues they were going to face, thanks to the others experience. Failures of other known companies could have been an example for those who came after, who therefore engaged in proper preparation programs before to actually start their foreign direct investment. The latter idea is supported by the fact that also data relative to the *time of first investment* show a similar score distribution, meaning that companies who entered earlier in the market suffered a higher LOF from the beginning. Additionally, when we compare the difference of average scores of the same group in different times, we see that the oldest group records the largest decline in LOF, which is not significant but suggest that these firms could have actually experienced more improvement than younger counterparts, despite the transforming external environment.. As it will be discussed later in related sections, no connection between age and type of legal entity chosen or previous export activity in China is resulting from data available.

Another reason for the higher LOF experienced by older subsidiaries could be the goal they are pursuing in China, or the possible change of related strategy ongoing. For instance companies who moved into the market earlier could have done it for reasons different from those who did it more recently. Moreover those reason, valid at the time of establishment, might no longer be convenient anymore. Higher levels of liability of foreignness reported by managers in older firms than could be either directly related to the reason the company is in China for, either related to a change of this reason, and the subsequent change in strategy and possible challenges involved in it. In order to check whether these theories are supported, at least in the sample, we can see table 8 below where a list of reason and related average scores assigned by respondents in each group is shown. Also in this case managers where asked to rate the single reason from 1 (irrelevant) to 5 (fundamental).

Table 8 – List or reasons to operate in China | Average score per age group

Reason to operate in China	**0 -1**		**2 - 5**		**5 +**	
	2016	**then**	**2016**	**then**	**2016**	**then**
Low labor cost	1,75	1,75	1,77	2,23	1,60	2,80
Availability of cheap raw materials	2,00	2,00	1,92	1,62	1,80	1,40
Availability of skilled labor force	1,00	1,00	1,46	1,31	1,80	1,80
Availability of R&D capabilities	1,25	1,25	1,46	1,38	1,00	1,00
Logistic advantages	4,25	4,25	2,23	2,00	3,60	3,00
Fiscal advantages	2,25	2,25	1,85	2,08	1,80	2,20
Development of a “new” end market	4,25	4,25	4,31	4,38	4,80	4,40
Competitors are in the market	2,25	2,25	2,46	2,69	4,60	4,60
Lower constraints as concerns environment laws	1,75	1,75	1,15	1,15	1,40	1,40
Lower constraints as concern work force rights	1,25	1,25	1,15	1,15	1,60	1,60
Other	2,00	2,00	1,31	1,31	1,00	1,00

We can instantly notice that Development of a new market is, and was before, in every age group the highest rated reason to be in China. This is not though what we are looking for. From the table we can see that older firms rated on average the presence of competitors in the market as one of the main reasons to operate in China, while firms in the other two groups do not rate this reason as so important. Actually the intermediate group (2 to 5 years) do not shown any other very important reason on average. According to respondents in the third and youngest group instead, logistic advantages are as important as the development of a new market to be in China; the same reason is rated with quite a high score (third highest) also from the oldest group. In addition logistic advantages grew in importance from the *time of first investment* for both the intermediate and oldest group, underlining the increasing relevance of China as a logistic hub in the globalized economy. Since there are, at least partially, different reasons to operate in China in the three groups, LOF could be affected also by this aspect.

For what concern instead the change of importance of reasons to operate in the market, as expected there is no change in scores of the youngest group, which represent companies who have just set-up their subsidiary. The other two groups instead appear to be increasingly changing their strategy compared to what it was at the *time of first investment.* While several strategies seem to be changing just a little in the intermediate group, where the largest change in the average score is a reduction in low labor costs reason (not significant though), in the oldest group only five strategies have a different score from the *time of first investment*, but these changes are larger, especially for what concern the low labor costs reason. The total net change – in absolute value – is indeed higher for the *2 to 5 years* group and even higher for oldest group. This is no surprise considering that a possible change in strategy is to be expected over time, but nonetheless these changes could give origin to additional liability of foreignness.

If we look back at table 7, we can see that some drivers have a larger variation between groups, and it's worth to look deeper into them. Consistently with the average driver data, many drivers appear to be increasingly more concerning for older firms and this is valid also for answers relative to the *time of first investment*. Respondents in the *5 or more years* group rate several issues as more worrisome than the intermediate group, even though in some cases is the younger group to be ahead. Compared instead to the *0 to 1 years* group, ratings of the oldest group are definitely higher. T-tests conducted on single drivers confirm that some differences are significant.

In particular firms in the oldest group (more than 5 years) rate discrimination against foreign companies and brand more concerning compared to the other two groups with a level of significance of 95%; the difference is smaller and not significant between the two younger groups. The stronger effect of discrimination on companies with more than 5 years of experience, as perceived by managers, might be due to the aforementioned change of strategy or goals that these companies appears to be undergoing. These changes could bring the subsidiary in touch with new players and situations in the market for what they cannot count on the established customer or supplier base and the experience they already have. These findings, and the fact that in every group the score is stable or increasing, are consistent with what Eden and Miller (2004) suggest: costs resulting from discriminatory behavior are not likely to decrease over time.

Both the drivers unclear regulations and bureaucracy and licensing requirements were rated higher (with significance of 95%) from respondents in the oldest group. In this case though the difference is significant only with the *0 to 1 years* group, not with the intermediate. This is due probably because of the high variance characterizing the intermediate group. Moreover for what concern bureaucracy, the two oldest groups have similar average rating. How to explain the fact that older firms are suffering more LOF due to unclear regulations or bureaucracy, when you would expect instead the opposite, consistently with the previously discussed literature? A possible reason could be that latest entrants are more prepared to this uncertainty. In fact if we look at answers relative to the *time of first investment*, we instantly notice that rating were higher for the same groups of firms also at the beginning of their experience, suggesting that the issue was probably very concerning from the beginning. We can also notice that the two drivers, for every group, are a rising concern compared to when companies moved into the market: both their rating in fact increased over time, probably due to the economic reforms ongoing which of course affect the whole population.

It's interesting to notice that corruption, non-qualified workforce and constraints on non-managerial human resources were rated with the same level of criticality between the three groups: these three problems therefore look to be not dependent on the years of activity, and are maybe related to other variables. One more note is worth on cultural distance driver, which is reported as more concerning from respondents in the intermediate group; very high variance levels in both the *0 to 1 years* and *more than 5 years* groups make very hard to interpret this finding though. Other than the above few exceptions, all the other drivers not mentioned in this section follow a common path: increasingly more concerning for older groups, but no significant difference was found.

Country of origin

The country of origin is an interesting classification and can be useful to check whether the available sample reflects some of the theories discussed before. Moeller et Al. (2013) for instance maintain that nationality of the company itself could be a driver of liability of foreignness since it could influence consumers' response to firms' products or brand and can have a significant impact on quality perception. In order to analyze the sample I split it in two groups, one including Italian companies (12 in total) and one including companies form all the other countries (10 firms, the full list can be found at the beginning of this chapter). I am aware that this is not an ideal division because of the variety characterizing the residual group, but I proceeded in this way because there were not enough firms from another single country to be put in a group by themselves. In this way we can at least compare answers from managers in Italian companies as compared to others.

Table 9 – List of drivers of LOF | Country groups analysis

Column	**1**		**2**	
Country groups	**ITALIAN *(12)***		**OTHERS *(10)***	
DRIVERS	**2016**	**then**	**2016**	**then**
Intellectual Property Right Infringement	3,08	3,08	2,90	3,30
Chinese protectionism	**2,50^{2}**	**2,58^{2}**	**3,50^{1}**	**3,80^{1}**
Geographical distance	2,58	2,75	2,20	2,80
Language differences	3,00	3,50	3,50	3,60
Cultural differences	3,58	3,92	4,00	3,90
Discrimination against foreign brands/companies	2,17	2,08	2,80	2,30
Bureaucracy and Licensing requirements	3,25	3,33	3,80	3,40
Unclear regulations	3,58	3,50	3,90	3,40
Corruption	2,92	3,17	2,80	3,00
Difficulties in finding suitable local partners	**4,00^{2}**	**4,08^{2}**	**2,80^{1}**	**2,80^{1}**
Work force not qualified	2,75	3,17	3,30	2,90
Management-level human resources constraints	2,83	3,00	3,60	3,30
Non-Management-level human resources constraints	2,33	2,33	2,70	2,90
AVERAGE DRIVER	**2,97**	**3,12**	**3,22**	**3,18**

Legend: Drivers in **bold** present significant difference. Symbols next to numbers represent significant difference with data from the other period e.g. *then* (*), or the same set of data in column one (^{1}), two (^{2}).

From a first look to table 9, where results of the analysis conducted are shown, seems like countries from the group Others report overall a slightly higher LOF overall compared to Italian firms, even though the difference is not significant. Although Italian respondents declared a small decrease of the average rating over time, according to managers in the group Others the average score is substantially unchanged from the *time of first investment*. The possible reason of these different behaviors are to be searched in the single driver scores: Italian companies record a small but general reduction for most of the drivers; in Other's group instead differences are bigger, but in both directions. Considering the variety characterizing the latter group, which includes enterprises from no less than 5 countries, it's not surprising that differences are so inconsistent.

Since there are no significant differences in the overall score, we should look deeper into single drivers rankings. Finding a suitable local partner is one of the most concerning issues according to managers in the Italian group, and it was a main problem in the past as well. The score assigned to this driver is not as high in the group Others though, and in fact I found significant (95% level) difference for both the time frames. The reason of this clear difference could be a different way of doing business, and looking for business partners, between groups; findings suggest that Italian companies could be used to practices not compatible with domestic players' ones.

Another significant difference (95%) is reported for the driver Chinese protectionism. In this case though the problem seems to be more concerning for Others companies than for Italians. Moreover the rating has declined in time for both the groups, even though the decrease is more noticeable in Others. Higher level of protectionism experienced by companies in Others could be caused by several things, and it's not easy to determine one considering that the group includes companies from different countries. We can only observe that somehow appears like Italian companies are less concerned by this driver of LOF.

The other drivers have no significant difference between groups, but two of them are worth to be briefly mentioned: discrimination against foreign companies and brands and management-level HR constraints. In both cases respondents in group Others rate higher scores for these problems compared to Italians. For what concern discrimination, a lower score for Italians could be explained with what Moeller et Al. (2013) say, and the findings might suggest that Italian companies or brands could "look better" in the eyes of Chinese public just because of their nationality. Constraints in HR management are considered to be a growing problem among Others respondents, while it seems to be decreasing for Italian companies; the combined effect is a clear higher rating recorded by the former in *2016* data set. This could be related to the appear-to-be smaller cultural and language difference that Italian companies declare compared to others, consistently with Newman and Nollen (1996) findings.

Industry

Liability of foreignness, or at least some of its drivers, can often be related to the industry where a company is operating. This is true especially in China, a country which is undergoing a massive transition to an advanced economy, one based on services and high-tech and above all on internal consumption. Together with the economic transition comes an institutional transformation: central and local governments are updating laws and regulations to keep up with the quick industry transition and many sectors, especially the newest ones, are involved. Moreover some industries are highly regulated or even restricted. If we add also that some sectors are now struggling while others are thriving, it’s easy to understand why the industry where a foreign company operates can really change the level of liability of foreignness perceived.

The sample was split into three groups in order to conduct my analysis. These groups were thought based on the expected similar external condition they face now in the market: Low-tech industry and primary sector (8 companies), High-tech and medium-tech industries (8 companies) and service sector (6 companies). Table 10 below highlights the main point of the analysis. The overall indicator of LOF, the average driver, tells us already something interesting: High and medium tech industries appear to be affected more heavily by liability of foreignness, and the difference with Low-tech and primary is even significant (95% level). Companies in the service sector are overall slightly less affected than High and medium tech enterprises, they are instead definitely more concerned than firms in low-tech and primary, but the difference was significant with a 95% level only at the *time of first investment.* Considering that high and medium tech and service industries are those undergoing radical changes, the fact that companies in low-tech industry are perceiving less Liability of foreignness is not surprising. Low-tech and primary sectors although are now going through an economic slowdown in China, at least compared to the other groups, so they should also be affected. The reason is probably that the slowdown is involving both foreign and domestic players, not influencing therefore the level of liability of foreignness.

After the analysis of single drivers, many interesting information can be discussed. Even though only in two cases I have found significant difference – discrimination against foreign brands and companies and geographical distance – almost every problem is worth a comment.

Table 10 – List of drivers of LOF | Industry groups analysis

Column	**1**		**2**		**3**	
Industry groups	**SERVICE *(6)***		**HIGH/MED TECH *(8)***		**LOW TECH *(8)***	
DRIVERS	**2016**	**then**	**2016**	**then**	**2016**	**then**
Intellectual Property Right Infringement	2,33	2,83	3,50	3,13	3,00	3,50
Chinese protectionism	3,17	3,83	3,50	3,25	2,25	2,50
Geographical distance	2,33	2,67	**3,13**^{3}	**3,50**^{3}	**1,75**^{2}	**2,13**^{2}
Language differences	3,00	3,33	3,50	4,13	3,13	3,13
Cultural differences	3,83	3,83	3,50	4,00	4,00	3,88
Discrimination against foreign brands/ companies	2,33	2,00	**3,38**^{3}	**2,88**^{3}	**1,63**^{2}	**1,63**^{2}
Bureaucracy and Licensing requirements	4,00	4,17	3,25	3,13	3,38	3,00
Unclear regulations	4,17	4,00	3,63	3,38	3,50	3,13
Corruption	3,17	3,67	3,00	3,13	2,50	2,63
Difficulties in finding suitable local partners	3,17	3,33	4,00	3,88	3,13	3,25
Work force not qualified	2,67	3,00	3,00	3,25	3,25	2,88
Management-level human resources constraints	3,50	3,33	3,38	3,63	2,75	2,50
Non-Management-level human resources constraints	2,83	3,00	2,63	2,75	2,13	2,13
AVERAGE DRIVER	**3,12**	**3,31**^{3}	**3,34**^{3}	**3,38**^{3}	**2,80**^{2}	**2,79**^{23}

Legend: Drivers in **bold** present significant difference. Symbols next to numbers represent significant difference with data from the other period e.g. *then* (*), or the same set of data in column one (^{1}), two (^{2}) or three (^{3}).

Let's first take into consideration those drivers where a 95% level significant difference has been reported: geographical distance is considered more concerning by respondents in the high and medium tech industries compared to the low-tech and primary industry, then and now. The service sector appears to consider the issue slightly more worrisome than the latter, but no significant difference was found with neither. The fact that geographical distance is much more a problem for the high and medium tech managers could suggest the need for more investor control and higher level of coordination in advanced and complex processes. The need for control is easily understandable if we consider that for these companies a loss of knowhow could be definitely more concerning than for companies in other groups. In addition we should keep in mind that in situations where more complex processes are involved the interactions between actors are reciprocal and geographical distance (and in this case also time zone differences) can negatively affect coordination.

Discrimination against foreign companies and brands are rated differently in the three groups although it doesn't seems to be one of the biggest concerns: following the same course of geographical distance, firms in high and medium tech seems to experience more discrimination, with a significant difference (95%) compared to low-tech and primary sector companies; also for this driver the rating among service companies is lower than high and medium tech but higher than low tech and primary, and no significant difference was found for it. Discrimination towards high and medium tech firms is not intuitive: the reason behind in fact could be the growth of the new value-added Chinese industry, the same which is supposed to substitute the low quality mass industry as powerhouse of Chinese economy. These new local companies in the high tech sector could have attracted the attention of Chinese customers, increasing the effect of discrimination (the rating is actually increasing from the time of first investment). The same thing is not valid for low tech industry, where the majority of domestic players still focus on price competition.

As just mentioned also those driver where no significant difference was found between the groups can give us some insight on the most concerning issues. For instance looks like service firms suffer less LOF due to IP law infringements compared to other groups, and the lack of significance is maybe caused by high variance. This output makes sense in fact service companies are in general less concerned about trademarks and patents infringement. Also the shift to a more advanced industry in the country is maybe represented by an increase of rating in high and medium tech and decrease in low tech and primary group since the *time of first investment.* The issue of patents and trademark maybe reflects also on the difficulty to find a suitable partner, which is rated overall even as more concerning: high and medium tech group although report a higher score compared to the other two group, suggesting that maybe finding a trustworthy partner is more difficult when it comes to dealing with patents and knowhow in general.

Protectionism is more concerning for high and medium tech managers, followed by respondents in the service group. These findings were to be expected given the already discussed non-tariff barriers existing strategic sectors. Since the Chinese government is pushing towards a necessary modernization of industry and economy in general, these industries are subject to restrictions and stricter control and therefore should suffer higher levels of LOF.

Both bureaucracy and unclear regulation seems to be more concerning for the service industry, even though not significantly. Maybe the reason behind these results is the nature of the industry: these firms need more than other groups simpler rules to operate efficiently and slow bureaucracy and uncertain environment affect them more.

When we look instead at HR related issues, we can see that both management and non-management level constraints are considered to be more worrisome in the service and high and medium tech industries. No surprise that more advanced industries require more effort for an effective HR management. Nonetheless looks like when it comes to finding qualified workforce is more difficult or concerning for respondents in the low tech and primary group, according to who the issue is also getting worse from the *time of first investment* in contrast with the other two groups.

Legal entity

The choice of legal entity to establish a subsidiary in China mostly depends on the need that a company has: for example if the goal is market research, development of a new market or nurturing the relationship with local partners a Representative office should be enough. If instead a foreign enterprise wants to sell or manufacture goods or provide services directly with the subsidiary itself, a bigger investment in a WFOE or JV is required. In our sample we have all three of them, in particular 6 ROs, 13 WFOEs and 3 JVs. The small number of JVs in the sample is probably representative of the entire population. WFOEs in fact are much more common among foreign investors thanks to the simpler procedure of establishment and the lack of need for a local partner.

When we look at the results of the analysis in table 11 we instantly realize that there is no noticeable difference between the average driver rating of different groups. It’s necessary to check more detailed data to collect some useful information. Some drivers in fact were found to be significantly (95%) different among groups.

Table 11 – List of drivers of LOF | Legal entity groups analysis

Column	**1**		**2**		**3**	
Legal entity groups	**RO *(6)***		**WFOE *(13)***		**JV *(3)***	
DRIVERS	**2016**	**then**	**2016**	**then**	**2016**	**then**
Intellectual Property Right Infringement	3,17	3,50	3,00	2,69	2,67	4,67
Chinese protectionism	2,67	2,67	3,15	3,23	2,67	3,67
Geographical distance	**3,33**[3]	3,33	2,15	2,54	**1,67**[1]	2,67
Language differences	**3,83**[2]	3,83	**2,77**[13]	3,46	**4,00**[2]	3,33
Cultural differences	4,33	4,67	3,54	3,77	3,67	3,00
Discrimination against foreign brands/ companies	2,50	2,00	2,54	2,31	2,00	2,00
Bureaucracy and Licensing requirements	4,00	3,67	3,23	3,23	3,67	3,33
Unclear regulations	3,33	3,50	3,85	3,38	4,00	3,67
Corruption	2,17	2,50	3,15	3,15	3,00	4,00
Difficulties in finding suitable local partners	**4,17**[3]	**4,33**[3]	3,46	3,46	**2,00**[1]	**2,00**[1]
Work force not qualified	2,67	2,83	3,08	3,23	3,33	2,67
Management-level human resources constraints	2,83	3,00	3,15	3,23	4,00	3,00
Non-Management-level human resources constraints	2,33	2,50	2,54	2,54	2,67	3,00
AVERAGE DRIVER	**3,18**	**3,26**	**3,05**	**3,09**	**3,03**	**3,15**

Legend: Drivers in **bold** present significant difference. Symbols next to numbers represent significant difference with data from the other period e.g. *then* (*), or the same set of data in column one ([1]), two ([2]) or three ([3]).

The most intuitive finding is the huge gap between the low score assigned to difficulties in finding local partners by JV managers, compared to the rather high score given by managers in the other two groups. JVs have, by definition, already found a local partner and we couldn't expect any different result. Also the lower concern shown by respondents from JV group in regard of discrimination against foreign firms, despite the difference is not significant, is understandable. The JV is in fact partially owned by locals, and therefore is maybe considered as less foreign by the public.

The scores assigned to the language difference issue follow an interesting path: according to both RO's and JV's respondents on average this problem is more concerning than for companies in the WFOEs group – significant difference at 95% level for ROs and 90% level for JVs. The reason behind it could be different for the two cases: rep. offices are less integrated in general with the local market, and often they do not employ local staff, thus they could perceive the language distance as a bigger problem compared to other companies. JVs instead are very integrated and the language barrier is probably experienced on a daily basis, bringing along higher level of LOF.

The third driver I have found a significant difference between groups for is geographical distance: ROs seem to be more concerned about it compared to both WFOEs and JVs (even though the difference is significant only for JV group). This data suggest that probably the level of autonomy is related to the level of geographical distance perceived. A representative office in fact is highly dependent on the parent companies decisions, requiring more communication. WFOEs and JVs are in general more autonomous and therefore the need for coordination is lower. The scores assigned to cultural differences are consistent with literature (Di Maggio & Powell, 1983; Mezias, 2002), even if in this case there is no significant difference in the sample. An higher degree of integration boost the adaptation to the local environment and increase legitimacy. To be noticed moreover that for joint ventures cultural differences became a more concerning problem over time. This detail makes me think that maybe foreign managers of JVs, because of the partnership they have already implemented, expect not to experience a big cultural shock, but later realize that the joint venture itself is not enough to overcome LOF stemming from cultural differences.

When it comes to IP rights infringements, respondents from the JV group seems to be less worried compared to those in other groups. It was instead the opposite at the *time of first investment*, when the issue was rated extremely high by the same group. The possible reason is that given their close contact with the local partner foreign firms where very concerned about the problem. With time they instead realized that a local partner bring no harness to the IP rights, and it’s probably useful to reduce the related danger.

Unclear regulation and Corruption are both rated as less concerning in the RO group, while the score is similar for WFOEs and JVs. We can imagine that a rep. office, due to its limited scope of operations, is on one side subject to fewer laws and regulations, on the other side less involved in the relationship with government officials. Also HR constraints for managerial staff are a smaller concern for ROs. This of course has nothing to do with the relationship with authorities, but it might have with the complexity of operations. This is somehow confirmed by the higher rating given to the same issue by respondents in the JV group and it is also not so unexpected: probably with the increase of operations complexity dealing with local managers is more critical.

Export to China before establishment of subsidiary

The last variable I examined in relation to the list of drivers of liability of foreignness is the previous export activity to China, in other words whether or not companies engaged in any export operation to China before to step in the market with an FDI. According to literature associated with the Uppsala model a step-by-step entrance strategy can reduce the unfamiliarity with the foreign market and therefore reduce liability of foreignness. Also Hymer (1960) suggested that indirect investments are less risky and more suitable to approach a new market. The sample was divided then in two quite even group Export (10 firms) and No export (12 firms). Unlike what we would expect and more in line with Denk et Al. (2012) and Zaheer (2002) views, table 12 here below show that the average driver, proxy of liability of foreignness, present a basically equal score in the two groups, and no clear changes are noticeable from the *time of first investment*. We need therefore to analyze in detail the drivers and see if some useful information are retrievable.

At a first look we understand why the overall level of liability of foreignness seems to be the same between the two groups: several driver were rated differently from respondents in the two groups, and in some cases the difference is even significant (at a 95% or 90% level), but some issues are more concerning for companies who exported in China before, while some others are more problematic for who didn't. the overall effect is then of virtual equality in the LOF perceived.

Table 12 – List of drivers of LOF | Export to China before groups analysis

Column	1		2	
Export to china before groups	**EXPORT *(10)***		**NO EXPORT *(12)***	
DRIVERS	**2016**	**then**	**2016**	**then**
Intellectual Property Right Infringement	3,10	3,60	2,92	2,83
Chinese protectionism	**2,40²**	2,80	**3,42¹**	3,42
Geographical distance	**3,00²**	**3,40²**	**1,92¹**	**2,25¹**
Language differences	**3,80²**	3,80	**2,75¹**	3,33
Cultural differences	4,10	3,70	3,50	4,08
Discrimination against foreign brands/companies	2,40	2,20	2,50	2,17
Bureaucracy and Licensing requirements	3,60	3,50	3,42	3,25
Unclear regulations	3,80	3,50	3,67	3,42
Corruption	**2,30²**	**2,50²**	**3,33¹**	**3,58¹**
Difficulties in finding suitable local partners	3,50	3,60	3,42	3,42
Work force not qualified	2,70	2,70	3,25	3,33
Management-level human resources constraints	3,00	2,60	3,33	3,58
Non-Management-level human resources constraints	**2,00²**	**2,00²**	**2,92¹**	**3,08¹**
AVERAGE DRIVER	**3,05**	**3,07**	**3,10**	**3,21**

Legend: Drivers in **bold** present significant difference. Symbols next to numbers represent significant difference with data from the other period e.g. *then* (*), or the same set of data in column one (¹), two (²).

Starting from drivers who are rated as more concerning by the group who didn't engage in any export activity before, as suggested by the literature, we find that protectionism has a significantly (90%) higher score according to the No export group. Additionally over time firms who exported before also managed to apparently reduce the impact of the driver, while the other group didn't. Also the effect of corruption looks to be lower on companies who used to export before, with a level of significance of 90%. A possible explanation for both these drivers is that thanks to their previous export activity, companies already had implemented a group of local connections, probably using Guanxi, to reduce the effect of the two drivers and mitigate related LOF.

From an HR point of view, Export group appears to have easier life with both managerial and non-managerial staff. For what concern non-management level constraints, difference with No export group is even significant (95%). For the latter actually, dealing with non-managerial staff is almost as difficult as dealing with managers. It's possible that a previous experience could have given some knowledge of the market HR practices, even if only partial, maybe tapping local partners.

When we check instead the other side of the coin we see that both cultural and language difference and geographical distance are rated as more concerning from those companies who were exporting to China before the FDI. Considering then that two of them are also significantly different (both geographical distance and language differences at a 95% level), the findings are highly unexpected. For what concern cultural differences it's worth to notice that respondents' perception changed over time: seems like the Export group is perceiving as more problematic if compared to the *time of first investment*, while managers in the No export group think on average that the problem got better. The reason behind this opposite development could be found in the concept of perceived familiarity (Petersen & Pedersen, 2002). Companies in the Export group perceived to be familiar with the market at the *time of first investment* and didn't engage in much preparation, to find themselves stunned by a higher cultural difference than expected. Firms in the other group instead put a lot of effort before the FDI in order to be prepare, expecting very high cultural difference levels, and after an initial shock managed to mitigate the LOF.

It's hard to find a reason behind the scores assigned to language differences and geographical distance in this case: higher ratings from the export groups in fact were not expected for these two drivers, and are in contrast with the analyzed literature. A possible explanation could be the overconfidence these companies approached the FDI with, that brought them to underestimate the issue and be less prepared in comparison with companies who didn't export before who instead prepare themselves. An alternative view could be instead that the knowledge accumulated give these companies an insight into the market, letting them perceive higher LOF under these two aspects, or o the other side are companies who didn't export before to have undervalued these issues.

Conclusion

Thanks to my job in China I found myself in the position to contact several managers of companies that are currently active in the country, more specifically in Shanghai, and have a first-hand insight into the dynamics of Liability of Foreignness affecting companies here. A questionnaire then was sent out to several firms to interrogate managers on their experience about the business environment. The main analysis was conducted on a list of common issues faced by foreign companies, issues that are supposed to be then drivers of LOF. These drivers were then analyzed in relation to 5 population characteristics based on which the sample was split. As mentioned earlier the sample collected is smaller than expected and my findings are not to be considered definitive, but they can still trigger some interesting reasoning about the reflection of LOF theories on empirical data.

The analysis of drivers revealed that the most concerning issues according to respondents are *cultural distance*, *unclear regulations* and *bureaucracy and licensing requirements*. As already mentioned Chinese culture is very peculiar and deeply rooted also in the way of doing business therefore foreign companies, especially western firms like the majority of those who are in the sample, are all hit by a cultural shock. We have also discussed how the institutional framework is uncertain and how laws and regulations are in constant evolution and sometimes enforced inconsistently, making China a very complex market overall (Luo et Al., 2002). It's not surprising that almost every respondent confirmed the use – or at least the effort to implement – Guanxi connections in order to integrate better with business environment and compensate for the lack of established formal institutions (Peng, 2005).

In order to better understand the dynamics of LOF drivers the sample was split into groups formed on the basis of variables explained before, which were then analyzed singularly and compared. The first analysis conducted was on 3 age groups, where age stands for the number of years from the establishment of the subsidiary until now. The findings reveal a picture which seems to be very different from the expectations: while literature (Zaheer and Mosakowski, 1997; Petersen & Pedersen, 2002) and common sense suggest that older firms would be less affected by liability of foreignness thanks to their direct experience in the market, according to data collected, managers of older companies declare higher difficulties in several aspects, and the overall result is an apparent higher level of LOF for older firms.

The unexpected results can be due to multiple reasons linked to the type of learning engagement (Petersen & Pedersen, 2002) or to the goals pursued by the company in China. Older companies for example might have not engaged in pre-entry learning and have been hit by a stronger cultural shock compared to younger ones, which instead after learning from others previous experience engaged also in pre-entry preparation, reducing the impact of LOF. Despite older companies could have started at a disadvantage, why are they still perceiving levels of LOF so high after several years? The answer to this question is probably in the transitioning nature of the market: the continuous evolution of market conditions could have prevented companies to effectively acquire useful knowledge and experience, and therefore do not reduce LOF effects. On the other side older companies could perceive higher level of LOF because of the goals they pursued in the market at the time of their first investment. The change in market conditions could have hampered their operations and forced subsidiaries to reinvent themselves. Respondents in older firms for example report a decreasing importance of low labor costs and a growing importance of logistic advantages as reasons to stay in China; according to the newest companies logistic advantages are one of the top 2 reasons to be there.

Since Moeller et Al. (2013) suggest that the country of origin could influence the level of LOF, influencing public opinion about the company image as well as about the services or products it provides, the sample was divided into two groups, distinguishing between Italian companies and all the others. From the results seems like Italian companies suffer slightly lower levels of liability of foreignness overall, but the difference is so small that is worth to look deeper into single drivers. Some issues appear to be more concerning for respondents in Italian firms, while others follow an opposite path. Worth to be mentioned are difficulties in finding a suitable partner, considered significantly more concerning by Italian companies. The possible reason could be that Italian managers in particular are used to very different practices to those commonly used in China, practices that are instead more similar to those of other countries. For what concern protectionism instead, Italian companies apparently feel less concerned about the problem; even though we cannot be sure, the results suggest a possible positive bias towards Italian firms, reflecting in lower level of LOF perceived, as reported by respondents.

Liability of foreignness and some of its drivers can change between different industries, especially when some of them are more regulated or are quickly changing, like in China. To see how LOF effects change between sectors the sample was divided into three groups:

Service sector, high and medium tech industry, low tech industry. From a first analysis of the average driver, representing the overall LOF perceived, it appears that companies in the high and medium tech and in the service industries are more affected by liability of foreignness. These findings are not surprising considering that these two groups represent those industries undergoing the most radical changes, and therefore subject to higher levels of uncertainty.

We can find other expected results also in the analysis of single drivers. In particular the significant difference in the score of geographical distance reveals that firms in the high and medium tech industry look to be, as previously described, more concerned over the needs for coordination and parent organizational control. Discrimination against foreign firms is also considered more concerning by high and medium tech group respondents. The possible explanation lies in the growth of new domestic companies focusing on high-end markets in the high and medium tech industries. These local competitors are offering value-added products and are gaining reputation among Chinese consumers, to the detriment of foreign enterprises.

The decision over the type of legal entity chosen depends on the needs of a company: different legal entities have advantages and disadvantages, that we have already discussed, and can be affected in different ways by drivers of liability of foreignness. As expected, joint ventures consider the issue of finding a local partner not as concerning as it is for other groups, indeed these companies have already found at least one by definition. Geographical distance is a bigger concern for representative offices, compared to the other two groups: probably the direct dependence of this type of entity from the parent company increase the need for coordination and therefore the perceived distance. Language barriers apparently manifest themselves in two different ways: they are a main issue for ROs that are as mentioned above less integrated with the local environment, and often do not employ local staff. Joint ventures on the other side are constantly in contact with their Chinese partner so, even though external language differences are lower, internal communication barriers are a daily concern.

Companies who engaged in export activities to China before to enter with an FDI in the country are supposed, according to theories associated with the Uppsala model, to suffer less LOF thanks to the experience and the market-specific knowledge gained. Our data although show a different picture: there is no apparent difference in the LOF perceived between the group of companies who used to export and the group who didn’t, consistently with Denk et Al. (2012) and Zaheer (2002). Protectionism and corruption are the two main drivers that No export group rated as more concerning compared to the other. Lower level of corruption and protectionism perceived are understandable given the chance that a local network of contacts has already been established during the export activities. Despite the two drivers are not directly related to the network of relationships, Guanxi can be useful to mitigate the effects of them, and therefore to reduce LOF. Of course the implementation of connections is also useful to tap general knowledge about the market even if it can be only partial. This knowledge could be enough to make companies well aware of the risks in the market, this might be a reason why firms who exported before rate geographical distance and language distance more concerning compared to the other group.

The lack of a numerous observations didn't allow me to run a full analysis on the data collected. Moreover not enough subsidiary performance data were provided by managers, neither sufficient information about the strategies implemeted. Also the chances to run a meaningful regression analysis were hampered by the small size of the sample. Nevertheless the simple analysis of ratings given to drivers of liability of foreignness and their influence on firm's operation, as well as the relation between what are the most relevant issues faced and other characteristics of the subsidiary itself – age, country of origin, industry, type of legal entity chosen, export activity before the FDI – gave us a useful insight into how empirical data reflect the theories previously discussed and their suggestions.

In conclusion, as already mentioned, my findings cannot, and don't want to, give final answers to how the effect of liability of foreignness influences foreign companies strategy or vice-versa, neither can provide definitive results on the causes of liability of foreignness. My goal is to provide empirical evidence that liability of foreignness is a complex concept, its causes and effects depend on the situation in which the company is and on the company characteristics themselves as shown by the results of my analysis previously discussed.

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ANNEX 1

YOUR COMPANY

Respondent's position in the Company

Director/functional leader of the department (HR director, finance director, sales director, etc)	☐
Director of the government relations or public relations department	☐
Director of Chinese operations	☐
Senior-level country manager (CEO, VP, GM, managing director)	☐
Other (consultant, lawyer, advisor, etc) please specify	☐

The primary industry in which the firm is engaged

Aircraft	☐	Leather and Shoes	☐
Pharmaceuticals	☐	Agriculture	☐
Electronics and computing machines	☐	Food and Beverages	☐
Medical instruments	☐	Retail, distribution and Logistics	☐
Electrical machinery and machine tools	☐	Information technology and information services	☐
Automotive and transportation equipment	☐	Reseach and Educational Services	☐
Mechanics	☐	Advertising and marketing	☐
Chemicals (no Pharmaceuticals)	☐	Financial services	☐
Rubber and plastic products	☐	Health Care	☐
Mineral products, petroleum products and basic metals	☐	Insurance and Bank	☐
Textile and apparel	☐	Real Estate and other firm services	☐
Home Furniture	☐	Other (please specify)	☐

In which of the following countries did the company sell its product/services in 2015. Please also indicate whether sales are decreasing, stable or increasing compared to 2014.

Area	2015 % of export	Decreased	Stable	Increased
Europe		☐	☐	☐
North America		☐	☐	☐
South and central America		☐	☐	☐
Middle East		☐	☐	☐
Africa		☐	☐	☐
Asia (excluding China)		☐	☐	☐
China		☐	☐	☐
Australia and Oceania		☐	☐	☐
Total Exports	100%			

In what areas does the firm have subsidiaries? Please indicate the number of active subsidiaries in the past 3 years for each of the following geographic areas. Please also remark the activities conducted by the subsidiaries in the area.

Area	2015	Commercial	Sourcing	R&D	Manufacturing	Logistic	After sale
Europe		☐	☐	☐	☐	☐	☐
North America		☐	☐	☐	☐	☐	☐
South and central America		☐	☐	☐	☐	☐	☐
Middle East		☐	☐	☐	☐	☐	☐
Africa		☐	☐	☐	☐	☐	☐
Asia (excluding China)		☐	☐	☐	☐	☐	☐
China		☐	☐	☐	☐	☐	☐
Australia and Oceania		☐	☐	☐	☐	☐	☐

	2014	Commercial	Sourcing	R&D	Manufacturing	Logistic	After sale
Europe		☐	☐	☐	☐	☐	☐
North America		☐	☐	☐	☐	☐	☐
South and central America		☐	☐	☐	☐	☐	☐
Middle East		☐	☐	☐	☐	☐	☐
Africa		☐	☐	☐	☐	☐	☐
Asia (excluding China)		☐	☐	☐	☐	☐	☐
China		☐	☐	☐	☐	☐	☐
Australia and Oceania		☐	☐	☐	☐	☐	☐
	2013	Commercial	Sourcing	R&D	Manufacturing	Logistic	After sale
Europe		☐	☐	☐	☐	☐	☐
North America		☐	☐	☐	☐	☐	☐
South and central America		☐	☐	☐	☐	☐	☐
Middle East		☐	☐	☐	☐	☐	☐
Africa		☐	☐	☐	☐	☐	☐
Asia (excluding China)		☐	☐	☐	☐	☐	☐
China		☐	☐	☐	☐	☐	☐
Australia and Oceania		☐	☐	☐	☐	☐	☐

CHINA OPERATIONS

Year in which the Chinese subsidiary was founded

Before its first investment in China, did the firm export to China? yes ☐ no ☐

Which of the following legal entities is your company in China?

Legal entity	
Wholly foreign-owned enterprise (WFOE)	☐
Representative office	☐
Joint venture	☐

Distribution of shareholder equity of the WFOE (Wholly Foreign Owned Enterprise)

Shareholder	Type of shareholder*	% of equity	Is the shareholder active in firm management?
shareholder 1	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐		yes ☐ no ☐
shareholder 2	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐		yes ☐ no ☐
shareholder 3	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐		yes ☐ no ☐
Other (if any)	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐		yes ☐ no ☐
		100%	

*1 foreign resident individual, 2 Chinese resident individual, 3 Chinese firm, 4 foreign firm, 5 bank or financial institution

How many employees does your company have in China now? How many did it have at the end of the first year of activity in the country?

	2016	First year
Investor's Country Expatriates		
Local Chinese		
Third Country Expatriates		

Revenues and margins of the WFOE in the past three years, in Euros

	2016 (forecast)	2015	2014
Revenues			
Net Operating Profit (EBIT))			

Please indicate the proportion of R&D / Sales expenses out of revenues for your Chinese subsidiary

	2016 (forecast)	2015	2014
Proportion invested in R&D			
Proportion invested in Sales and Marketing			

Did the company use third party assistance for its entry in Chinese market? Please specify which and rate its degree of effectiveness in helping the company in a scale from 1 (irrelevant) to 5 (fundamental)

	Recourse to the institution	Degree of effectiveness				
ICE (Italian institute for foreign commerce)	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Italian Embassy	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Chamber of Commerce	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Italian banks	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Italy-China Foundation	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Other (please specify)	☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐

Which of the following activities is the company currently conducting in China?

	Activities in China
We produce final products/services and sell them in China	☐
We produce final products/services and sell them in investor's market	☐
We produce final products/services and sell them in third countries (no China and Investor's)	☐
We produce components or parts of the product that are exported in other market to be completed	☐
We buy raw materials and components for the end-product, which is produced in Investor's market	☐
We sell products/services produced in Investor's market	☐
We sell products/services produced in other countries (no China and Investor's)	☐
Other (please specify)	☐

Please assess the reasons for your presence in China on a scale from 1 (irrelevant) to 5 (fundamental) now and the reasons why you first invested in the market.

	Nowadays					When you first invested with an FDI				
Low labor cost	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Availability of cheap raw materialis	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Availability of skilled labour force	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Availability of R&D capabilities	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Logistic advantages	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Fiscal advantages	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Development of a "new" end market	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Competitors are in the market	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Lower constraints as concerns environment laws	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Lower constraints as concern work force rights	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐
Other (please specify)	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐	1 ☐	2 ☐	3 ☐	4 ☐	5 ☐

What are your priorities for investments in China now? What were when you first invested in the country? You can mark more than one. Please indicate the priority with numbers (with 1 standing for top priority)

	Nowadays		First investment	
Increase production capacity	☐		☐	
Market research	☐		☐	
Increase/improve local supply chain (localization)	☐		☐	
R&D	☐		☐	
Search/retain skilled labor force	☐		☐	
Search for new client/distributors	☐		☐	
Other (please specify)	☐		☐	
No investment	☐		☐	

Which of the followings, based on your personal experience, do you think are the most relevant issues when doing business in China? Which were before?Please rate them in a scale from 1(irrelevant) to 5 (critical)

	Nowadays	When you first entered
Intellectual Property Right Infringement	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Chinese protectionism	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Geographical distance	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Language differences	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Cultural differences	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Discrimination against foreign brands/companies	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Bureaucracy and Licensing requirements	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Unclear regulations	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Corruption	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Difficulties in finding suitable local partners	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Work force not qualified	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Management-level human resources constraints	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Non Management-level human resources constraints	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Other (please specify)	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

Please mark how useful your company considers the following strategies to overcome the major issues faced. Is the efficacy changed compared to the beginning? Please rate them in a scale from 1 (not useful at all) to 5 (fundamental). In case the strategy has never been used, do not mark any level.

	Nowadays	When you first entered
Product differentiation (strong brand)	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Import know-how/technologies from the parent company	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Create a local network of contacts (“Guanxi”)	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Contract protection	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Preliminary market studies/resesearches	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Hire managers with experience in China or Asia	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Strict investor control	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Expatriate management in loco	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Local Management in loco	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Use of parent company organizational practices	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Copy local competitors behavior	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐
Other (please specify)	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐	1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐

Do you think, overall, that the company has improved in overcoming issues related to its foreignness over time?

Got worse	☐	No changes	☐	Small improvements	☐	Substantial improvements	☐