

Piotti, Geny

**Working Paper**

## German companies engaging in China: Decision-making processes at home and management practices in Chinese subsidiaries

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MPIfG Working Paper 09/14

Geny Piotti

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Decision-Making Processes at Home and

Management Practices in Chinese Subsidiaries

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anck Institute  
for the Study of Societies

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## **Abstract**

This paper attempts to explain why internationalization processes to China are growing despite the significant difficulties that foreign direct investments into China encounter. The answer to this question can be found in the processes of decision-making on internationalization at the company level and how these affect management practices in Chinese subsidiaries. The argument I put forward in this paper is that for the small and medium-sized enterprises the study focuses on, the decisions concerning investment in China are mainly the product of structural and legitimation pressure. Structural pressure can encourage cognitive mechanisms and behavioral consequences similar to those occurring when individuals (and organizations) cope with threat. Legitimation pressure can foster wishful thinking, which pushes actors to believe that desired options are good despite evidence to the contrary. These pressures have an impact on how well companies are prepared when they internationalize and can particularly affect some crucial management practices, leading to inefficiencies and problems in subsidiaries.

## **Zusammenfassung**

Warum steigt die Anzahl der Unternehmensverlagerungen nach China, obwohl westliche Unternehmen dort auf große Schwierigkeiten treffen? Aufschluss darüber können unternehmerische Entscheidungsprozesse geben, die der Unternehmensverlagerung zugrunde liegen, und deren Auswirkungen auf Geschäftsführungspraktiken in den chinesischen Niederlassungen. Ich argumentiere, dass mittelständische Unternehmen, auf die sich das Interesse dieser Studie richtet, sich vor allem wegen struktureller Zwänge und eines hohen Legitimierungsdrucks zu einer Investition in China entscheiden. Strukturelle Zwänge können kognitive Mechanismen auslösen und Verhaltensweisen hervorrufen, die mit Reaktionen von Individuen (und Organisationen) auf eine Bedrohung vergleichbar sind. Legitimierungsdruck kann Wunschdenken fördern und Akteure dazu bringen zu glauben, die gewünschten Optionen seien gut, obwohl Beweise für das Gegenteil vorliegen. Diese Zwänge haben somit einen Einfluss darauf, wie gut Unternehmen auf eine Internationalisierung vorbereitet sind, und können wichtige unternehmerische Maßnahmen entscheidend beeinträchtigen. Dies führt in der Folge zu Ineffizienz und Problemen in den Niederlassungen.

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## Introduction

How can the growing numbers of internationalizations<sup>1</sup> into China be explained against the problems associated with foreign investments in China?

Western companies have increasingly internationalized in recent years, and large companies are not the only ones to have done so: small and medium-sized enterprises have also been increasingly attracted by the prospect of gaining new markets and economizing on production costs (OECD 2004; Kinkel/Lay/Maloca 2004; European Commission 2003). Investment in China and other low-wage countries has become very important in the last decade, as has investment in Eastern Europe (Kinkel/Maloca 2008). However, the results of such investment are at best ambiguous.

A recent survey on German production firms in China is in one way optimistic, insofar as a large majority of companies questioned did indeed appear to have reached at least most of their original targets, whatever those targets were and regardless of the years of market presence. When it comes to actual indicators about profitability, however, the study results are less encouraging: for the German companies surveyed, 30 percent of Chinese production subsidiaries required from 2 to 4 years to reach the break-even point. Twenty percent reached it only after 4 or more years of market presence in China, and a further 20 percent were not producing profitably at all.<sup>2</sup> Compared to companies that specialize in production, the trade and services sectors have experienced much more rapid development. Almost 60 percent of the companies in these sectors have reached the break-even point within two years (AHK/EAC 2008). A study conducted by Deutsche Bank shows that profitability is still an open question in China and that efficiency of investments is going down (Deutsche Bank Research 2004).<sup>3</sup> This is occurring despite the increasing number of relocations to China. All in all, researchers agree

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1 Internationalization is, of course, a general concept that includes all kinds of strategies, from the exporting or establishment of a company's own subsidiaries to international outsourcing. The meaning of internationalization used in this paper is much more limited and refers to the cases in which companies decide to build their own subsidiaries in China. Internationalization is a much more politically neutral term than relocation, which gives the idea of a zero-sum game between production – and hence employment – in the home country and in the foreign subsidiary. The use of the term internationalization also finds support in literature that identifies different types of multinationals: internationalists, federalists and global maximizers. According to this literature, the strategies of SMEs resemble the internationalist model more closely than the federal or the global one (Goshal 2002; Yip 2002).

2 Companies that had returned to Germany through the years were not included in the sample.

3 The efficiency of investments is measured by the incremental capital-output ratio (ICOR), i.e., the marginal amount of investment capital necessary for an entity to generate the next unit of production. ICOR has been constantly increasing in China since the mid-nineties, which underlines the decreasing efficiency of investing in China. The indicator does not make any distinctions between Chinese and foreign direct investments or between foreign direct investments either. Nonetheless, analysts consider it to be an indicator that enables comparability among countries.

on the fact that success in China, if it is ever to be achieved, requires time, much more time than in other countries, as well as a rethinking of business strategies.

The present paper, which centers on work in progress, aims to illustrate how the decisions that companies make on investment in developing countries can affect management practices in their subsidiaries in the host country and lead to problems in performance in those companies. To achieve this goal we must consider two different fields in the analysis: the field where the decision-making on whether to internationalize occurs, or the social and cultural context where the company's headquarters are located, where entrepreneurs construct their identity, and where they attach value to new organizational options such as, in this case, that of internationalizing,<sup>4</sup> and the field where the investment actually takes place, where business might function in a different way because of different structural characteristics, cultural traits and/or political institutional regulation (Westney 2005). Decision-making within a company's headquarters strongly influences the way in which managers of subsidiaries cope with the local context. Especially in the case of SMEs, where subsidiaries are strongly dependent on headquarters (Goshal 2002), the decision-making process in headquarters can continue to have consequences for how subsidiaries operate, and hence affect performance.

In my analysis of the decisions and practices of small and medium-sized enterprises that invest in China, I build a general framework of decision-making that brings together macro and micro perspective and different approaches that are rarely combined in economic sociology research, in particular the perspectives of structural, cultural and cognitive embeddedness (Zukin/DiMaggio 1990; Beckert 2003, 2008). The paper argues that decisions to go to China are mostly the product of structural and legitimation pressure.<sup>5</sup> Structural pressure can encourage cognitive mechanisms and behavioral consequences similar to those that occur when individuals (and organizations) cope with threat. Legitimation pressure can instead foster wishful thinking, which pushes actors to believe that desired options are good despite contrary evidence.

These pressures behind decisions have an impact on how far companies have prepared before they internationalize, especially regarding certain crucial management choices that can lead to inefficiencies and problems in subsidiaries established in transitional countries such as China. I will place particular emphasis on the criteria for management recruitment in the Chinese subsidiary and the development of conflicts between parent companies and management in China.

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4 This context might not coincide with a particular national or regional culture if the field in which the company operates is potentially global (Jones 2008).

5 While structural pressure coincides with the concept of structural embeddedness, legitimation pressure is mainly situated in the domain of cultural embeddedness. In order to explain how institutionalized models of behavior are propagated, however, it is necessary to take the interaction between the structural and cultural dimension into account.

The paper focuses on small and medium-sized German enterprises that have decided to open representative offices and/or production plants in China, and my conclusions are based on qualitative research conducted in Germany and China that builds on a multiplicity of methods.

In section 1, I will deal with the role of structural and legitimation pressure in the process of internationalization. In section 2, I illustrate the cognitive mechanisms generated by those pressures. Section 3 is devoted to the description of the method. Sections 4 and 5 present the results of the empirical research. I expand on the influence of the above-mentioned constraints on the attitudes that SMEs have towards internationalization into China and show how these attitudes affect management practices in the subsidiaries such as management recruitment and relationships with the Chinese subsidiary.

## **1 Structural pressure and legitimation pressure**

Economic sociology literature has often underlined the enabling character of networks, and structural embeddedness more generally (Granovetter 1985, 2005; Coleman 1988; Burt 1992; Zukin/DiMaggio 1990). However, in some cases networks can also exert constraints on actors' behavior (Portes/Sensenbrenner 1993; Uzzi 1997). Not only does this mean that they may hinder desired action, they may also impose or strongly incentivize decisions that actors would not make voluntarily (Pfeffer 1992; Fligstein 2001).

In fact, the decisions by entrepreneurs and managers regarding internationalization processes are often conditioned by structural aspects, which derive from the company's position within the production network. Despite the emphasis of transaction costs theory on the possibility to opt freely for hierarchical, market or network-based forms of governance, depending on the institutional setting of the target country, for example the asset of property rights (Williamson 1979, 1985), the national and global economy has had an increasingly networked kind of governance structure (Castells 2000; Gereffi/Korzeniewicz/Korzeniewicz 1994; Gereffi/Humphrey/Sturgeon 2005). Since the 1980s, large companies have increasingly and strategically decentralized their production (Dankbaar 2007), and lean production, albeit in hybrid forms, has been applied across countries (Tolliday et al. 1998). Networks have become a dominant form of governance beyond the borders of nation states, in spite of unfavorable institutions in the host countries.

Logistic coordination is particularly strong in hierarchically coordinated networks, and therefore reciprocal dependency can become very high. Suppliers' relationships are in fact characterized by obligations and expectations: quality and just-in-time are delivered in exchange for stable cooperation in the medium to long term. When companies diversify the portfolio of suppliers for individual components, however, they can be-

come less dependent on single suppliers and keep control on prices, forcing suppliers to compete with one another.

Because of the combination of cooperation and competition, decisions taken in the center of the network by more powerful actors, for example by assemblers, have an impact on the whole network in hierarchically coordinated network structures (Hirsch-Kreinsen 2002). The influence exerted can range from soft pressure all the way to determining the choices of other network members. The decisions on first or further internationalization processes by small and medium-sized enterprises, especially decisions on investment in developing countries, are certainly an example of the influence of hierarchically coordinated networks on the economy. Large companies can decide to internationalize as a means of market expansion, to start new economic relationships or tighten and develop previously existing ones.

Although inter-firm relationships in networks are characterized by high mutual dependence and coordination, radical decisions taken by assemblers might not be followed voluntarily by suppliers, because of the high investment and risk associated with those decisions. However, the exit option on the part of suppliers may be actively discouraged by means of additional clauses in the supply contracts that include negative or positive incentives associated with commitment.

Decentralization and outsourcing processes that are already widespread in the home country are thus also replicated in the internationalization processes. In fact, the processes of vertical disintegration of enterprises and of specialization along the supply chain are to a certain extent irreversible and path-dependent (Dankbaar 2007). Once the outsourcing has taken place, specific production phases cannot be easily re-internalized unless the ownership structures change and mergers and acquisitions or further forms of strategic partnership occur (joint ventures or integration of companies in groups, for instance). Larger companies may not wish to internationalize in developing countries alone, which would imply internalizing risk in uncertain markets.

Besides the pressure that originates from the structural embeddedness of companies, issues of legitimation also play a part in boosting internationalization processes. Legitimation pressure is linked to what is considered to be appropriate according to institutionalized models of behavior (DiMaggio/Powell 1983; Meyer/Rowan 1991). These are linked to dominant ideas that become widespread in the field that companies operate in and foster the adoption of models of behavior and particular practices coherent with those ideas and models. Fligstein (2001) refers to the concept of “conception of control” to indicate “the set of understandings and practices about how things work in a particular market setting” (Fligstein 2001: 35). These practices do not consist solely of their technical or organizational contents; they are imbued with symbols that companies make their own. In addition, following of legitimate models of behavior is also a source of prestige and thereby contributes to the creation of status hierarchies within their field (Podolny 1993; Fligstein 2001)

Professional associations, consulting companies and public discourse can be reasonably considered as important sources of legitimation pressure inside fields and networks. They exert legitimation pressure because they help generate, reinforce and disseminate models of behavior and organization strategies.

Institutional theory of organizations has emphasized how associations support isomorphic behaviors among organizations (DiMaggio/Powell 1983; Fligstein 2001). Associations provide information as a club good and organize meetings in order to foster networking and problem-solving. Since strategies of action are formulated and discussed within these meetings, they also help by defining and diffusing standards. The diffusion of organization strategies on a global scale, for instance, might be the result of global consulting companies offering their support to and effectively stimulating organization convergence all over the world (Meyer 2000). Meetings organized by associations are also social arenas, in which status hierarchies become visible and to a certain extent are reconstituted. In cases of uncertainty about the quality or value of a particular good or service (in this specific case, about the organization strategy to be adopted in order to maintain or increase competitiveness), adopting a particularly high-prestige and high-status organizational solution helps actors to reduce uncertainties associated with organizational change. What is more important in our case, however, is that status has transitive properties, which means that it can be transferred in social relationships (Podolny 2005): newcomers may see their status increase if they choose to adopt the organizational solutions approved and practiced by the higher-status actors.

But how do particular strategies become high-status and legitimate? Public discourse plays a very important role alongside associations and consulting companies. Ideas and paradigms discussed in academia find their place through the discourse, where they are associated with and add support to appropriate organizational solutions. They provide information on the strategies of other economic actors and foster imitation processes (Piotti 2009). Public discourse can also contribute to constructing reality: in our case, it can provide an image of a country like China, about which knowledge is difficult to acquire for single actors.

## **2 Deciding under pressure: Two cognitive mechanisms**

Institutional analysis of organizations has shown that the adoption of organization strategies is not a matter of efficiency. The dissemination of organization forms follows social mechanisms such as isomorphism that do not naturally tend to efficiency, but rather can contribute to the “wrong” option being selected and propagated, since social actors are cognitively limited (Simon 1955; Elster 1989a, 1989b; Zukin/DiMaggio 1990; DiMaggio/Powell 1983).

This paper also deals with that cognitive side, but it does not point so much to the role of cognitive constructs such as frames, scripts, cognitive maps<sup>6</sup> or even personality traits (Miller/Dröge 1986; Meiner 2000; Zahra/Santeri Korri/Yu 2005). Instead, the focus here is on the rationality failure that can occur when decisions are made under pressure in a situation of uncertainty (Zukin/DiMaggio 1990). I argue that cognitive mechanisms play an active role in explaining why socially constructed models of behavior might lead to inefficiencies and costs, while I assert that we must also consider the influence of the external environment on these mechanisms (Zahra/Santeri Korri/Yu 2005).

Cognitive and social psychology have pointed to cognitive biases that systematically lead to deviations from rational behavior. These biases can derive from reliance on judgmental heuristics, e.g. assessing probabilities and predicting values (Tversky/Kahneman 1974). People may unconsciously adapt to the opportunity set and try to reduce the cognitive dissonance that arises when they have contradictory beliefs, attitudes, or feelings, or behave in a manner that is inconsistent with such beliefs, attitudes, or feelings (Elster 1985; Festinger/Carlsmith 1959). Moreover, people can attach excessive importance to past and personal experience and tend to look for or interpret new information in light of what they already know or believe and, conversely, to neglect information that contradicts their own knowledge or beliefs (Ross/Lepper/Hubbard 1975). This can also happen as a result of motivation. Actors, in fact, may persevere on the same (heretofore unsuccessful) strategy because of the potential desired opportunities associated with its success (Nickerson 1998; Elster 1989a).

I have already underlined that processes of internationalization may primarily result from structural and legitimation pressure. We can now ask how these pressures affect entrepreneurs and their decision-making on internationalization. I refer in this paper to two kinds of mechanisms in particular: the rigidity-threat cycle and wishful thinking. Different kinds of cognitive bias are likely to occur in each, particularly the restriction of information processes and the reliance on one's own experiences, beliefs, and behaviors, especially if the effects of such behaviors are desirable.

When structural pressure generates an obligation to internationalize, it is usually in order to fulfill the requirements of other economic actors situated in higher positions of the supply chain or to respond to competitors. At the same time, internationalization induces high investments and risks that suppliers might not be willing to bear but must bear unless they want to lose their competitive edge. The structural constraints mentioned above lead to high uncertainty and can be interpreted as threats that can undermine company stability, since investment and production must be undertaken in very different environments.

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6 Cognitive constructs are very closely related to culture (DiMaggio 1997; Dequech 2003; Beckert 2010; Weick 2001; Tversky/Kahneman 1981). Their importance is indirectly accounted for by pointing out the role of legitimation pressure, as has been done in the previous section.

Staw, Sandeland and Dutton (1981) have constructed a model of individual and organizational response to threat<sup>7</sup> to explain how this can lead to maladaptation. In cases of adverse environmental conditions that could potentially endanger individuals and organizations, the authors observe two main effects that lead to rigidity and hence to maladaptation: restriction of information processing and constriction of control.

Restriction of information processing means that the number of alternatives considered in order to face the threat is limited. At the individual level,<sup>8</sup> this means that actors tend to respond to a given threat by emphasizing previous expectations about their environment. The alternatives considered at the organizational level are limited, but not necessarily because of a general use of fewer sources of information. The authors in fact emphasize that in organizations the search for information is high at the beginning, when the actors realize the threat, then decreases as an effect of information overloading, and finally increases again after a decision has been made on how to address the threat. Rather it is the content of the information that is affected by the restriction of information processing: even if the search for information is intensified,

the number of genuinely new or novel alternatives considered by organizations may still be relatively low. [...] information received is likely to be similar to that of the past, due to heavy reliance on standard operating procedures, previous ways of understanding, or communication that is low in complexity. (Staw/Sandelands/Dutton 1981: 513)

At the beginning, organizations search for information in order to confirm the existence of the crisis; at the end, they search for information to find evidence that reinforces the correctness of the decisions that have already been made.

Constriction of control at the individual level manifests itself in the use of dominant and familiar responses. In organizations it derives from the tendency to centralize authority, i.e. to concentrate decision-making at the top of the organization and to reduce the number of participants in that decision-making. One way to do this is to tighten control and standardize activities.

Staw, Sandelands and Dutton (1981) observed that rigidities in behavior are likely to result from threats where no alternatives are perceived and where the information available, based on simple messages, encourages actors to pursue the only option of which they are aware.

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7 In their article Staw, Sandelands and Dutton (1981), compare literature analyzing reactions to threats by individuals, groups, and organizations, and suggest that there are strong similarities between reactions at the different levels of analysis. Since decisions in SMEs are often taken by individuals – mainly the entrepreneur – I consider the responses to threats at the individual and organizational level jointly. With the overlap between these two levels in companies, it is no wonder that similarities in behavior occur.

8 The authors refer especially to the consequences of psychological stress, anxiety and physiological arousal. They also consider studies on the effects of disasters.

When companies feel an obligation to go to China, they are not likely to search for information about alternative options. They will instead seek out information that confirms the necessity to go to China and possibly justifies it. This search is facilitated if the China option is regarded to be a good choice in the public discourse and becomes a dominant option. The decision will be made at the top of the hierarchy and justified by previous experience (for instance in Germany or in other countries). The “rigidity-threat effects” identified by Staw, Sandelands and Dutton (1981) at the individual and organizational level can be applied not only to the phase of decision-making about investing in China, but also to the phases that come after the decision, when the subsidiary in China is up and running and the effects are less encouraging than expected. In this situation, the decision-makers at headquarters are likely to rely rigidly on previous experiences and expectations and to distrust local managers even at the cost of adapting badly to the new context.

As we have already seen, companies’ decisions to internationalize can result not only from structural pressure but also from legitimation pressure. Legitimation pressure is related to ideas about how business should be carried out, i.e. models of organizational behaviors that entrepreneurs have accepted and consider prestigious, models that help to increase a company’s status if they are adopted. Acceptance of these models might also depend on how the option of internationalization is framed in business meetings and events among entrepreneurs, as well as in public discourse.

What are the cognitive implications when a strategy enjoys particularly high legitimacy, is considered to provide easy solutions to many problems, or is expected to increase profits enormously with few side effects? One likely consequence is well described by the concept of wishful thinking. According to Elster (Elster 1989a), wishful thinking can be defined as believing the facts that fit one’s desires. It is a cognitive status in which beliefs are “contaminated” by passions. The impact of desires on beliefs can be direct – actors simply believe reality as they would like it to be despite evidence – or indirect – actors go so far as to selectively collect the evidence that supports those beliefs and stop collecting when enough evidence has been accumulated to justify decisions based on wishes. This rationality failure caused by irrational beliefs is strongly related to problems of myopia and short-termism.<sup>9</sup> Wishful thinking is inspired by the pursuit of the greatest immediate pleasure and therefore “yields powerful short-term gratification that can prove irresistible” (Elster 1989a: 51). Plausible consequences, especially when the supporting information is very easy to collect and many other actors are pursuing the same strategy, can be an excess of confidence and euphoric behavior.

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9 Myopia can be defined as the inability to be moved by the future consequences of present behavior in a situation of intertemporal uncertainty, and it is considered here as synonymous with “short-termism” (Laverty 1996). Other authors distinguish between the two. Marginson and McCaulay (2008) e.g. define short-termism as a “preference for actions in the short term that have detrimental effects in the long term,” while myopia is defined as simple “difficulties of foresight,” or the product of cognitive boundedness.

Despite differences between the two types of pressure on companies towards internationalization and the cognitive mechanisms involved, at least one effect is quite similar. In both cases, decision processes lead companies to select information in support of the choice that actors are de facto compelled to take or that they very much wish to take. This can lead to a lack of preparation and strategy that affects how companies adapt in the new context.

### 3 Methodology

The empirical research detailed in this paper builds on the use of different methodological instruments to explore how much of an impact structural and legitimation pressure have had on entrepreneurs' decisions to go to China, and to establish cognitive mechanisms in decision processes and their effects on management practices. I conducted a total of 48 semi-structured in-depth interviews: 31 with German managers, 9 with Chinese managers in German companies and 8 with German institutional actors in China and Germany. The focus was on companies of the German *Mittelstand*. Manufacturing and services were equally represented.

I also conducted participant observation in two informal and three formal meetings for German managers and entrepreneurs in Shanghai and at three events on China in Germany. Finally, I carried out an analysis of the German press on China.

Since it was very difficult to obtain interviews without connections, the snowball technique turned out to be the most suitable recruitment strategy. This meant that I had to rely on the "community definition" of *Mittelstand*, which is closely related to the German Institut für Mittelstandsforschung (IMF) definition that holds an SME to be any company with less than 500 employees and with up to 50 million Euros of turnover. The mix of interview partners – managers in the German headquarters and in the Chinese subsidiaries, as well as institutional actors in Germany and China – was particularly well-suited to exploring the decision-making process in Germany and its effects in China at the same time.

With my participation in formal and informal meetings, I aimed to glean information outside of the more artificial context of the interview, explore peer dynamics, and gain further interview contacts.

The analysis of the press on China is mainly intended to give an account of the image that the German media has constructed of China and show the basis on which decisions about China have been formed. The analysis is based on a selection of articles between 2001 and 2007 in the most important national newspapers, each with a different political orientation: *Frankfurter Allgemeine Zeitung* (FAZ), *Süddeutsche Zeitung* (SZ), *Die*

*Welt* and *Frankfurter Rundschau*. The articles in this selection were obtained through a search using the LexisNexis database for articles that contained the word “China” in the title and the words “relocation” (*Verlagerung*), “offshoring” or “economy” (*Wirtschaft*) in the title or text. I obtained 104 articles, which were then imported and analysed with the software Atlas.ti.

#### **4 Going to China: Structural and legitimation pressure and their effects on cognitive attitudes**

This section presents empirical evidence that decision-making about internationalization into China has mainly been the result of structural and legitimation pressure. These pressures push cognitive attitudes, such as rigidity and wishful thinking, that might cause maladaptation.

##### *Structural pressure*

The role played by structural pressure is very well illustrated by what a manager of a German medium-sized enterprise said in an interview about why his company decided to go to China.

Well [laughing]. It was substantially more mundane than you would think [...], we're also responding to our existing customers, who expect us and our service to be located here. So it's like a caravan. For example, first the automobile industry and the electronics industry started producing here. Then their direct suppliers did so, and in the third round we had to be here as suppliers of suppliers [...] and it goes on like that. Yes. That was the substantial reason, and I don't believe anyone thought very much about China before they went to China. It was like, "it's time, now we have to go there [...]." About like that. (U18)

Both the power asymmetry and mutual dependency between large enterprises and suppliers affect suppliers' decisions to go to China. The internationalization strategies these suppliers implement then rebound on their own suppliers further down the production hierarchy. Decisions by first movers to involve suppliers in their production activities in China are also conditioned by institutional host-country constraints that potentially increase the risks for first movers to produce in China alone.

As the case of the automobile industry in China emblematically shows, at first markets were too small to absorb the high production volumes that would allow for economies of scale. Moreover, the quality produced by local suppliers was too low or the efforts in terms of skills transfer too high for the large company, since no appropriate vocational training system was locally available (Depner 2006). The Chinese Government finally took action in various forms, such as strong local content constraints on multinationals.

This would embed them into the local production structure so that it could attract further investment, ensure technological transfer (Lubman 2006) and avoid the “cathedral in the desert effect” (Grabher 1996).

More interesting to observe is that structural pressure pushes SMEs to make decisions they otherwise would not. These decisions are unlikely to be well thought-out or undertaken with the necessary preparation. The consequences of this action will be clear later on. Moreover, since the networks in which German SMEs are embedded are potentially global, not limited to the national borders, the pressure to relocate to China can originate from outside the national production context as well.

The second strong structural constraint, which is analytically separate but acts jointly with the others, is generated out of competition. Decision-making by companies does not take place independently from decision-making by competitors. Indeed, pressure on prices exerted by competitors who have already made the jump to production in low-wage countries certainly pushes entrepreneurs to adopt similar internationalization strategies, as illustrated by the below quote:

We know that competition from China has been increasing for approximately the last ten years. We have a big competitor, a German company from the Wuppertal area. They went to China 15 years ago and have been producing there for the European market, now exclusively. And we noticed this [pressure] strongly, concerning the prices. Products are qualitatively good. They had their start-up difficulties, but after three to five years they had their product quality under control. And since then they have had clear price advantages. This was the background [to our internationalization]. (U1)

The role of competitors can be even more subtle, however, and need not even be real. Rather, it is increasingly mediated and stimulated “fictively,” by hierarchically coordinated networks. In the case of pressures exerted by more powerful economic actors, companies act on the basis of the assumption that customers will make the same proposal to the companies’ competitors. The company will then make decisions on the basis of what they *believe* their competitors are likely to do in this situation. Such beliefs are also based on legitimate models of companies’ behavior.

### *Legitimation pressure*

Among SMEs, I identified two basic institutionalized models of behavior and conceptions of control that push companies in the direction of internationalization. They have developed independently from each other but act jointly in the case of structural interdependency between companies. The first model can be called customer-oriented. This is not the product of internationalization, but of the more general processes of decentralization of production and outsourcing mentioned in the last section. Customer orientation may have been conceived by SMEs as profit-making strategy, but it has now also become a part of their corporate philosophy and is linked to issues of loyalty and

responsiveness. When the process first began, engaging in China mainly consisted of expanding geographically in order to maintain existing business relations.

As one manager efficiently synthesizes it:

Since “customer oriented” is written on our company banner, [...] we said that we have to be where the target markets are. (U1)

A second highly symbolic model of behavior can be synthesized in the image of the “global player,” according to which companies have to be able to invest and to adapt very flexibly to different contexts according to market needs. This idea has emerged as part of the processes of internationalization and globalization in large companies. As internationalization strategies of suppliers have become desirable for OEMs, the global player image has rubbed off on the supply chain as well.

If you do not produce worldwide, okay [...], of course you can do that, but let us assume now that the customer says “Okay, well, you [the company] can’t do that. There is nothing wrong with you, but you produce only in Germany or in Europe. We’re sorry, but we’ll take a *global one* [supplier].” (U18)

If suppliers refuse to follow their customers and to internationalize, they risk incurring penalties, such as the loss of contracts in the home country, or losing favor to competitors. They would have to acknowledge that their own company is not able to be “global” enough. Being a global player means at least three different things. Given that globalization is considered to be the most important challenge for companies nowadays, refusal to play the global game affects the reputation of suppliers about their capacity to respond to the customer’s needs.

At a more symbolic level, being a global player at any level of the production hierarchy is a source of prestige. Managers who are engaged in China sometimes refer to companies with plants “only” in Eastern Europe as “not really global.” Since these companies have invested just beyond Germany’s borders, they are not doing anything special. According to the entrepreneur quoted below, prestige plays an important role, and peer pressure can help transform the matter of prestige into a trend.

It’s better not to go [to China] only because it is fashionable or chic, because [you want to say] “I have branches in China as well.”

*Question:* Has this been your experience?

Of course! It is a question of prestige! You wouldn’t believe how far businesses go to present themselves in a positive light! I think there are people who engage in production abroad because it is fashionable. (U2)

Being a global player is also a source of status, because it means that companies are part of the circle of those who can address the new challenges posed by globalization and adopt strategies considered to be consistent with such challenges (Podolny 1993). I will illustrate how status is transferred when I deal with the role of associations.

## The sources of legitimation: Business meetings and the discourse on China

Between 2006 and 2007, Germany's Chamber of Commerce played a large part in organizing some initiatives on China all over Germany. Judging from interview material and participant observations, the public success of such initiatives was quite evident. One German manager in Shanghai reported to me on a meeting on China in Germany in which he had participated some months before. Since he had been away from Germany for a long period of time, he was very surprised to see so many people at a meeting on China and asked a journalist sitting next to him why it was so crowded. The journalist answered, "you just have to say China and people will come," suggesting a sort of irrational, euphoric behavior behind the widespread interest in China one sees in the business world.

The aim of these meetings on China is to provide information and clarification and to facilitate exchange of experiences, sharing of problems and discussion of solutions. However, the events are framed and organized in a way that could affect the decisions made by their audience of entrepreneurs and managers.

Once the moderators are introduced, the floor is usually ceded to guest speakers who introduce themselves and their businesses before they begin. The constellation of actors invited to speak may vary depending on the aims of the event, i.e. whether the focus is on presenting experiences in China or deals with problems and solutions. Those generally invited to speak at these events are either consultants or other service providers, representatives of Chinese provinces, or entrepreneurs/managers.

In the business meetings on China that were empirically observed, the China option for companies was never framed in a negative way, even when problems were discussed during the event. In fact, the introductions at these events mainly functioned to highlight the importance of the meeting and the reasons why it had been organized. The usual reasons given were the growing importance of China as business location or the need to know more about the location, so that companies could take advantage of or improve upon the opportunities available there.

A crucial role is played by the entrepreneurs and managers who are invited as guest speakers to educate the public on their experiences in China. The companies presenting at these events do not do so just to produce a public good, i.e., information for other companies who may be interested in investing in China. Since they also have the opportunity to present their own company, promote it, and possibly improve business, they may spin rosy success stories that can affect the decisions of others. Companies initially present the experience in China in a very positive light, and only in case of specific, more critical questions from the audience do they go into details about difficulties. Even when debating problems, the managers invited to give testimonials tend to reduce the significance of such problems and provide simple solutions for the audience in order to meet the expectations of the organizers and avoid public shame. This

is particularly true when hot issues like corruption and plagiarism are being discussed. Guest speakers are more willing to confess problems in informal conversations after their public presentations than when they are on stage. Problems encountered in China, if ever mentioned, tend to be presented as a lesser evil relative to the long-term negative consequences for the German company had it not invested in China at all. Thus production and market expansion into China is presented as an obligation for any company that wishes to remain competitive.

These meetings also function as arenas where status hierarchy is constructed. Going to China has increasingly acquired legitimacy and is perceived as a prestigious and profitable option for companies. The status of those who have adopted the China strategy will therefore increase with the number of the social interactions and rituals they can participate in, as they gain more visibility and associate themselves with such strategies. It is not uncommon for presenters to ask those in the audience with a subsidiary in China to raise their hands; it may simply be used as a rhetorical device to stimulate participation. What the speaker is in fact doing, however, is transferring his higher status – having already gone to China and been selected by the organization to speak – to those in the audience who have also implemented his strategy.

Status can also be constructed through the exchange of business cards. When participating in events on China, entrepreneurs and managers with businesses in China tend to offer business cards in the Chinese way: with both hands and the full focus of their attention. This is popular among Germans with Chinese business interests not only when they are in China, but also when they are in Germany. The ritual that in China and in Chinese business has the function of indicating deference to the partner, to show commitment to the culture or, more simply, to avoid conflicts and misunderstandings, has been turned into a signal and a symbol of community affiliation. Analogous to the previous example, the exchange of business cards also creates a line of separation and status differentiation between those companies who are in China already and those who are not.

The discourse on relocation and internationalization processes in the media has created additional legitimation pressure. Because of its high frequency in the press and the arguments used, the discourse on China from at least the first half of this decade tended to reinforce the investment trends in China even further. In 2004, there was an average of one article per week on China and relocation published in either the *Frankfurter Allgemeine Zeitung* or the *Süddeutsche Zeitung*, the two most important national newspapers in Germany: a heavy frequency for a relatively marginal topic. As far as the content is concerned, I have shown elsewhere that, since the beginning of the 1990s, the German public debate on the processes of internationalization of enterprises has been closely linked to the debate on the crisis of the German model and the role of the state in the economy (Piotti 2009). Sometimes the relocation of production has become a weapon, used by economic and institutional actors to speed up reforms toward deregulation, increase flexibility in industrial relations and work relationships, and reduce fiscal pressure for companies (Ahlers/Öz/Ziegler 2007).

While the general discourse on German relocation has especially underlined the push factors for relocation, the discourse on China has also emphasized the pull factors extensively: the opportunities associated with investments in China. This has created a distorted image of the risks associated with investing there.

As shown in the analysis of the most frequent concepts and concept combinations appearing in the press on China (Table 1),<sup>10</sup> the image of China presented is mainly associated with cheap production, low labor costs and positive performance. Only since the second half of this decade has China also been described as a booming country, characterized by high growth rates and an immense market.

It is only since 2006 and 2007 that the risks of investing in China, particularly the problems of opportunism associated with the violation of property rights, have been denounced in the press, which means only after the boom of German investment into China in 2004 and 2005.

Given that the messages in the German press on business internationalization in general and into China in particular could have provided companies with ideas that link competitiveness to relocation and with arguments in favor of investments into China, respectively, the question is to what extent the discourse in the press has had an impact on actual business decisions and why.

Managers and experts in China mostly agree on the fact that the public debate in the press is able to affect decisions and they provide different reasons for why it does. A key aspect to be considered when discussing the topic is the relationship between discourse and social structure. In fact, one of the reasons why discourse on China has conditioned the decision-making process in SMEs is that it fosters imitative processes among economic actors that can be likened to following a new fashion. This is made clear in the quote reported below, provided in an interview by a representative of a Chamber of Commerce in Germany specializing in the legal aspects of investing in China.

[Producing in China] is clearly a question of fashion. There are of course some economic “hard facts” [export surplus and growth rates]. India is the same thing. The growth rates are enormous. India already had these growth rates before, but the media had not picked up the topic. We can observe it clearly: when the media picks up something, the demand for the information we have increases. (I01)

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10 Using the “word crunch” function provided by the software Atlas.ti, it was possible to obtain a list of all possible words in the articles. The following step was to select and group words into relevant concepts for the analysis. The text could be automatically encoded on the basis of those concepts. In order to simplify encoding, synonyms such as “cheap” (*billig*) and “low-priced” (*günstig*) were encoded with the same code (“cheap”). Words (nouns, adjectives or verbs) with the same stem were encoded with the same code, generally that of the name. For example “risk” (*Risiko*), “risky” (*riskant*) and “to risk” (*riskieren*) were all encoded as “risk” (*Risiko*). The next step was the careful monitoring and revision of the results of the automatic encoding. Since Atlas.ti can transform qualitative documents into an SPSS matrix, which allows for easy quantification, it was possible to count frequencies of codes and code combinations in the same sentence.

Table 1 Most frequent concepts combined with China  
(press on China 2001–2007)

Concept	Frequency
Production	34
Relocation	25
Cheap	18
Rising	18
Growth	17
Positive	18
China positively framed in sentence	16
Market	22
Risk	15
Labor	14
Positive performance +	13
Cheat	11

Source: own calculation. Analysis carried out with Atlas.ti software on *Frankfurter Allgemeine Zeitung*, *Süddeutsche Zeitung*, *Die Welt* and *Frankfurter Rundschau* newspaper articles stored in LexisNexis.

Given the similarities in formal indicators between developing countries, the difference in the flux of investments to those countries thus seems to depend on the type of information provided by the media. The debate in the media is able to arouse emotions by putting out positive or negative images of those countries. The media can change beliefs about when to increase competitiveness: it can make the investment strategies of other actors public, or provide justifications for internationalization decisions as well as status incentives (Piotti 2009). It contributes to the process of defining what is legitimate in the economy and what is considered obsolete and doomed to fail. The public discourse provides measures of competitiveness among companies and as soon as legitimate behaviors become widespread, it fosters peer pressure. As a representative of the German Center in Shanghai put it:

This is a normal process taking place, and emotions definitely always play a role in decisions. If the press writes something positive on a topic [such as China], entrepreneurs in SMEs do not want to be the only ones in their entrepreneurial circles who are not in China yet. Of course a certain peer pressure is there. (I02)

Finally, the public debate seems to have a pronounced effect on decision-making in smaller companies, which do not have the economic means to commission market research and get enough information to be able to decide. Under conditions of uncertainty, which can be assumed to be higher for SMEs than for larger companies, entrepreneurs and managers rely more strongly on ideas and images of the world that circulate publicly and are discussed in entrepreneurial circles and associations (DiMaggio/Powell 1983).

The media has an impact on general public opinion, and this is really a part of the decision for entrepreneurs, particularly small entrepreneurs [...]. A multinational company would commission a multinational consulting firm here to conduct market research. Then they would have a very good idea of the market, as far as that is possible, in writing. Here are the costs, there are the returns, in such and such a time period. A decision can still be made, no problem. But small companies [...] cannot afford 50,000 or 60,000 euros of market research, which takes half a year. Public opinion is largely shaped from what everybody imagines, hears and figures out. (U36)

Structural and legitimation constraints constitute an important part of the framework within which entrepreneurs and managers make the decision to invest in China. For many entrepreneurs this choice is certainly made out of obligation. Locked into the logic of production networks, imprisoned by the need to be close to the customer or to be global, companies are forced to act consistently, even in the event of more risky investments. Besides this, the discourse on relocation and offshoring pushes the actors to consider such choices to be in their own interest and to provide justifications and rationalizations. Motivating factors such as prestige and legitimation, following a trend, or belonging to that category of companies that can address the new challenges of globalization all enter the decision process on internationalization.

### Effects on attitudes toward China

Interviewees were sometimes critical of the decision-making processes in SMEs that are the subject of this study. Besides the difficulties deriving from organizational and financial weaknesses more typical of SMEs than of large companies, they especially cited the lack of adequate reflection and preparation, the refusal to be supported by consultants, and the need to follow trends.

Institutional actors, for instance, have also underlined the general lack of foresight and the pursuit of short-term strategies even in what should actually be conceived as a long-term investment. Some managers have described the decision to go as “a jump into cold water.” What’s more, entrepreneurs tend to trust their experience without having any great knowledge of the Chinese context. As we will see, this has a particular influence on important decisions for the subsidiary, such as the choice of managers, as well as on the relationship between the company headquarters and the subsidiary in China. In order to explain why entrepreneurs apply short-term thinking to apparently rational and long-term investments, it is necessary to look at the influence that structural and legitimation pressure have on economic actors given their cognitive limitations.

We can distinguish two types of general effects on attitudes that are generated by the structural and legitimation pressure, respectively. In reality, the two types of pressures mainly act simultaneously, but for some companies the weight of structural pressure could be stronger than that of legitimation pressure.

For those companies in which structural pressure is stronger, because they are integrated into a supplier chain or because of competition, the decision to take the step to invest in China is more the result of a constriction, real or perceived. It is often a decision that these companies otherwise would not make voluntarily.

For many German companies, it is easy to notice [that going to China] is actually not wanted at all. They do not want to go to China; but they are under pressure, and therefore they have

to go. And this is where all problems start. Then they have a plant abroad that they actually do not trust. [...] I mean, to be honest, it is really questionable where all this will lead, whether this is the right way to do things. Because many companies are really high-technology enterprises, and these are actually out of place in China. They cannot actually produce more cheaply here in China than in Germany. Quite the reverse, producing here is often even more expensive. [...] The problem is that Germans do not really deal with China. You can increasingly see China on television, but you cannot process it correctly. You have to be here in order to really understand what is happening. And that is precisely the problem, the lack of understanding. They do not really deal with China. It is an obligation: we have to be there. And then, then, okay, we have to send people there. Then people get sent on the most ludicrous training courses, where you can learn how to hand over business cards. To be honest, it is completely idiotic and [results in] lost money, because [success] does not depend on this. (U48)

As emphasized by the German manager quoted above, when entrepreneurs invest in China they do so within a context they have never dealt with before and do not wish to deal with at all. They delegate the responsibility for their decision to invest in a Chinese subsidiary to others as they continue to trust in their own views of the world, even and especially when these are contradicted by the difficulties of producing in China that the managers there must address.

Legitimation pressure tends to give entrepreneurs a euphoric attitude towards investing in China and lead them into decisions that are driven by wishful thinking (Elster 1989a). As we have seen, wishful thinking occurs when actors cannot resist their own desires during the decision-making process and therefore select for evidence that does not contradict these desires. Both aspects of wishful thinking are clearly established the company behaviors described in the following two quotations, from a representative of the Foreign Chamber for Industry and Trade in Shanghai and a German manager, respectively.

Actually, it is difficult for us to convince companies that even if Shanghai might be a modern city, or China might now be partly an industrialized nation, it is still not so easy to make money. This is the real problem. You know, you arrive here at the airport, which is ultramodern, then you take the Maglev,<sup>11</sup> perhaps then you go to the Grand Hyatt, the highest hotel in the world, and look outside your window in the evening and say "Yes, here I will make my money for the next 30 years." It is not that easy. I only need to drive 50 kilometers outside the city to see poverty around me. This is where you have to consider China as somewhat more differentiated. And then I have huge competition here. I have to leave myself time to become acquainted with all this. Then I have to take a look at my competitors, look at the people in the shopping malls, I have to get a feeling [...]. As I said, people are to a certain extent too euphoric. Euphoria is never good in business. No matter where. (I12)

Coming here is really alluring. The market is simply there, which means it is also highly competitive. That is the next point. It is alluring. And basically every company, from global players like Bosch down to the smallest enterprises, everyone, I believe, imagines going to China to be easier than it actually is. (U18)

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11 The Maglev (Magnetic Levitation Train) is a high-speed train based on magnetic levitation technology. It has connected Shanghai Pudong with the Pudong Airport since 2003. The train takes 7 minutes and 18 seconds to complete the 30 km journey. It was completed through Chinese-German cooperation that included Siemens AG and ThyssenKrupp on the German side.

Entrepreneurs' behavior on China has been explicitly compared by some managers to the Gold Rush in America in the second half of the nineteenth century. Attracted by the prospect of reducing costs and expanding their markets – arguments that have been strongly emphasized in the discourse on the processes of internationalization into China – and blinded by the quick development and dynamism in Chinese cities, entrepreneurs have often decided to go to China based on overly high expectations.

I have suggested in my description of the sources of legitimation pressure that high expectations and euphoric behavior might be dependent on distorted information about China. However, as the previous quotations show, they are also the product of wishful thinking. Although distorted information can contribute to forming beliefs about the opportunities in China, clearly actors do not want to take the negative side into consideration and tend to neglect information that would call those beliefs into question. And the combination of distorted information and wishful thinking generates expectations that become temptations too difficult to resist.

The desire of the entrepreneurs to take part in the Chinese market – or, to repeat a metaphor used by managers, to ensure themselves a “piece of the pie” – pushes them to make decisions based on partial information, having little knowledge or experience of the Chinese context. These can turn out to be unproductive for the company. Thus entrepreneurs tend to overestimate the advantages and to underestimate the challenges of the Chinese environment, not only the cultural and institutional differences compared to Germany, but also the changing character of Chinese institutions, society and culture.

Structural and legitimation pressure can also exert an influence simultaneously. Those entrepreneurs who decide to invest in China more because of structural constraints than because of free will can make use of the discourse and its arguments to justify their decision to themselves and other actors, even converting the possibilities that the Chinese context offers into fact-based beliefs. In addition, they can benefit from the status and prestige of being a part of the peer group in China. Other companies can use customer pressure, even if in reality they have received only soft pressure from customers, as a justification for taking a step that they would have taken anyway, because of the bright perspective present in public opinion or a desire to enter the circle of global actors.

## **5 Doing business in China: Manager recruiting and headquarters–subsidiary relationships**

Structural pressure leads entrepreneurs to overestimate their own convictions about how business should be carried out and to distrust their own subsidiaries in China, while legitimation pressure pushes entrepreneurs to underestimate the costs generated in the new environment. The effect, at least at the beginning, is an excess of confidence.

But the two types of constraints tend to push companies into basically the same behavioral direction. Although investments in China should be considered as long-term investments, entrepreneurs tend to behave myopically. They want to get, or at least not to lose, the benefits that appear to be clear in the short run, without considering the consequences in the long run and without adequately preparing themselves first.

When companies engage in such wishful thinking and unwillingness to deal with the new Chinese context, while at the same time sticking to their own convictions, it can have a negative impact on important decisions made regarding the subsidiary. In the following section, I will show how these attitudes affect the criteria for recruiting managers of the subsidiary and the relationships between company headquarters and the Chinese subsidiaries.

### Management recruitment in the Chinese subsidiary

Entrepreneurs follow different approaches when recruiting managers for the subsidiary.<sup>12</sup> The first approach is to send managers and/or technicians from the headquarters to the subsidiary for a limited period of time and to substitute them with Chinese managers in a second phase, as soon as the company is operational. The second approach is to search for Chinese managers from the beginning. The third is to have two managers, one Chinese and one German, one of whom is appointed as general manager. Although all of these choices may sound reasonable, it is necessary to take a closer look at how and on what criteria they are usually made.

The first and most frequent approach is to send technicians or customer advisors from the headquarters to the Chinese subsidiary under a three-year-contract in which they build up the company, manage it during the start-up phase and then pass it on to a Chinese general manager when the three years are over. This type of approach has been criticized by some institutional actors, like the representative of the German Center in Shanghai quoted below, as an expression of “myopia,” a lack of strategic awareness and willingness by the SMEs to engage in necessary financial investment.

It is nevertheless wrong to pursue a long-term company strategy abroad with a short term, time-limited personnel policy [...]. Entrepreneurs do not behave in a manner consistent with their decisions. It is because they do not have any strategic thinker there in the company. If they had any, they would have to at least say theoretically: “If I have a long-term corporate strategy, I must also have people there [in China] on a long-term basis.” Then of course I look at my pot and who do I have at home? And then I realize: I don’t have anyone. Why? Because I have not in-

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12 A very simple analysis of the names of the managers of German companies in Shanghai in the database German Company Directory (<[www.german-company-directory.com/home](http://www.german-company-directory.com/home)>) in July 2007 showed that about 59 percent of German companies had a German manager, and 41 percent had a Chinese one.

egrated this [outsourcing] strategy into the company at all. On the contrary, the predominant strategy is to send someone for a short period of time and then make with locals [...], by having the completely wrong idea that they suddenly would be working for half the price. (I02)

Those who decide to send Germans usually also show a low capacity for trusting locals. But the choice to recruit locals can sometimes depend on wishful thinking. In practice, German companies turn to Chinese managers to lead the Chinese subsidiary because they are convinced that this will facilitate entrance into the Chinese market and simplify bureaucracy. Chinese managers are believed to have easier access to the local administration and to customers. The choice of this second approach is sometimes based on previous experiences of internationalization in already industrialized countries; it starts from the idea that it is necessary to construct local enterprises abroad instead of German ones. There may be other motivations behind this, however, such as (a) the refusal to deal directly with the more difficult side of working in China, for instance corruption or Chinese-style management of the Chinese labor force,<sup>13</sup> or, more often, (b) cutting costs, since the Chinese managers are systematically paid less than their German colleagues.

How are Chinese managers recruited? At least at the beginning, entrepreneurs tend to count on their own resources and intuition. They rely on contacts made during international fairs, particularly with managers who have been working in China for competitors and are willing to make a change in order to obtain higher wages or work in larger or more successful companies. Executives may place trust in previous sales agents who do not have any experience in establishing companies. It is not infrequent that previous interpreters or occasional translators during fairs become general managers in the German company that they previously translated for, or that young college graduates with some English language skills are recruited as general managers in the Chinese subsidiaries. As a consultant states:

German entrepreneurs have a completely strange conception of the people here. Many arrive here, they want to start their enterprise here and hire their interpreter. And they expect him to suddenly become a marketing specialist, a legal expert, a production manager, a real estate boss, everything at once. Because he is Chinese. "He's Chinese, anyway, he knows his way around here." It's as if I went to a cleaning lady in Germany and said to her: "Look at this 300-page contract about this 50 million [euro] project to see whether there might be a hook in there." I cannot expect the work to be done well, can I? [...] They genuinely believe it [...], especially the smaller ones. They think they have found a friend to take care of everything for nothing. The interpreter slowly transforms into a managing director that leads happily to a million- or a billion-[euro] enterprise in China later on. Bullshit! (C44)

The different approaches demonstrate the uncertainty generated by the need or desire to engage in China without experience. Entrepreneurs and managers may reproduce their usual repertoires of action in China. Sometimes, as illustrated in the previous

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13 The Chinese style of managing human capital is quite different from the Western one; German managers have defined it as very rude. Common practices include cutting wages and dismissing personnel if tasks have not been accomplished, and confiscating work documents from employees to avoid turnover.

quotation, they make decisions that they would never make in Germany in similar situations. Sometimes cost issues become the hidden deciding factors. Companies needing a Chinese presence might not be willing to spend more than what they believe is necessary based on their expectations and wishes. A consultant notes:

It used to be cheap once. You could get everything for a song. But you did not get anything sane in return; you get what you pay for. [Imitating his clients] “For a general manager, what should I pay?” “For you, 40,000 euros per year.” “What? So expensive! Is China that expensive?” “Well, I can also find someone for 10,000. But whether he leads you to success is another question.” [...] In Germany they can get at best a technical assistant for that price, certainly not a general manager that speaks three languages, is an engineer, has 15 years of experience and has worked for good companies. 40,000 is really not that much for them. But they get excited about it very quickly: “What? So expensive!” And then the company languishes [...] (C44)

As illustrated above, the conviction that in China everything is cheap is quite widespread at the beginning and pushes entrepreneurs to disbelieve that Chinese managers with experience could be expensive. The decision to recruit managers without experience in order to save on costs can jeopardize the performance of the subsidiaries.

To help German companies prevent the negative consequences of myopic behavior, the German Chamber of Commerce offers mediation services and basic consulting as a club good. Institutional actors, like the director of the German Center in Shanghai, also currently advise small and medium-sized entrepreneurs to recruit German general managers who have worked in China already and have planned to remain in China. This allows companies to meet three different needs at the same time: (1) a German manager who should be familiar with the German way of thinking, (2) a manager who has experience in China and 3) a lowering of costs. Since companies are willing to draw up local contracts without the costly options offered to the expats, the costs for the SMEs would definitely drop.

Some companies choose to have a German and a Chinese manager at the same time, with one of them performing the functions of a general manager and the other responsible for sale or production. The presence of two managers originates from the idea of joining the capacity to enter markets, which entrepreneurs think can best be guaranteed by the Chinese manager, with the technical capacity that the German manager is expected to have. German companies may award more powers to the Chinese manager as a way of showing respect and deference.

My research has shown, however, that this coexistence works well only if the two managers are able to establish good relationships that allow them to strongly reduce hierarchical and cultural differences. This means that the German managers have to be perceived to a certain extent as “Chinese,” and the Chinese manager in turn must be perceived as “German” or “Western.” Chinese managers sometimes refer to the metaphor of the banana: yellow outside and white inside. The split management will not work if the German manager uses a distanced managerial style and the Chinese manager follows a purely Chinese

style of management. The Chinese style uses hierarchy to exert power over the labor force, and hence even on the German managers, if they are situated at a lower hierarchical level. This can create difficult situations for the German managers, who lose their authority but still have to mediate between the needs of the headquarters and those of the Chinese subsidiary. It can also affect the company, since Chinese managers tend to take command of the company and can be difficult to control. Clearly the apparent economic advantages of having a Chinese subsidiary can overshadow the consequences of establishing dual management, particularly with a Chinese general manager who has more power than his or her German counterpart, during the process of decision-making.

### Relationships between headquarters and Chinese subsidiaries

The necessity to internationalize and the high expectations associated with internationalization have led small and medium-sized entrepreneurs to act myopically and to underprepare for the China challenge. This is reflected not only in “one-shot” decisions, like those on management recruitment just discussed, but also in the daily discussions between headquarters and subsidiaries, independent of the field of decision-making, the nationality (Chinese or German) of management or the management configuration (one manager or two with different nationalities and different powers).

Entrepreneurs may choose to address what they do not know or understand on the base of their own experience, repertoires of action, and information. They are often compelled to do so because of the pressure to go to China without wanting to or preparing for it, as well as the need to delegate management activities once they choose to establish a subsidiary. This can cause conflicts even in the best case, when the manager in the subsidiary stems from the parent company and can count on the trust of the German side. Such trust sometimes reveals itself to be very fragile, with relationships between the parent company and the subsidiary management becoming jeopardized as soon as business in China turns out to be more complex than expected, or changes in the parent company take place. For instance, if in the parent company the manager who encouraged the company to go to China decides to resign, the whole China project and the manager in China could be put into question. If the parent company becomes part of a larger group, the group might start to suddenly judge the performance of the Chinese company on the basis of different criteria, mainly standard short-term indicators. These indicators could be rejected by managers in the Chinese subsidiary, who may argue that they make absolutely no sense for a production location like China that requires a more long-term perspective. As soon as the German company has more orders to fill, the plant in China ceases to be a priority and, consequently, the requests of the manager in China as well.

Conflict can also arise when entrepreneurs decide to go to China because they have mainly followed shared models of behavior, have imitated others or because they have uncritically been attracted by the apparent advantages offered by the Chinese environ-

ment. In such a situation, executives in Germany might temporarily support their own decisions about management recruitment in the subsidiary and let managers work even if they are not actually satisfied with them because problems have arisen. After all, the German executives were the ones who made the decisions and defended them publicly.

Even in this case, however, the unexpected difficulties addressed by the Chinese subsidiary do not necessarily lead entrepreneurs in the German headquarters to question their expectations and develop more suitable strategies. Doing so would imply that they questioned the sense of their decision as a whole, which is to a certain extent irreversible, as well as the way they had successfully done business until that moment. Entrepreneurs tend to stick to their distorted ideas about China, their own convictions about how business should be done, preferring instead to question the capabilities of their managers in the Chinese subsidiaries.

The dissatisfaction among German entrepreneurs, particularly with their Chinese managers, may come from the fact that their recruitment decisions have been short-term, naïve and highly cost-oriented, as illustrated in the previous section. Very often, however, the executives on the German side may end up distrusting their managers and their way of doing business because of wishful thinking at the outset and an unwillingness to adapt to a context that they do not understand. This distrust can end up reinforcing their own determination to do business “the German way” that is supported by their own experience.

Conflicts between headquarters and subsidiaries in China are very frequent. Below I give three examples of situations in which the relationship between headquarters and subsidiary became characterized by conflict. In two cases, the conflicts led the management of the Chinese enterprise to resign their positions. The cases chosen are deliberately “best cases,” those which are supposed to have the best potential for success based on the criteria for management recruitment. That conflict can break out even in these best cases suggests that it would take place even more frequently in situations where decisions on management have been more naïve. The examples reported below cover different types of management configurations (one sole Chinese manager, one Chinese and one German manager, one sole German manager, respectively) and the two most important kinds of decision-making: on production activities and on market expansion.

The first example concerns the relationship between a Chinese manager and the German parent company. The Chinese manager had study and work experience in Germany. He was able to speak German and to mediate between the two cultures. Referring to the problems with the German parent company about market entry in China, he says:

Some German companies want to grow very fast, but the people sitting in headquarters do not know the market here that much. Of course they can read something from some of the information sources, but things are different from Germany or from what has been described to them. And then [they say] “What’s up? Why are we too slow?” or “Why are we too fast?” [...]

My ex-boss made a big strategic mistake. The demand in China is very high, and we had good machines at that time. Competition from other companies in Europe and in Germany is very rare. But the Chinese market is different. The whole world concentrates on China. Japanese and Taiwanese companies produce copied products and sell them on the Chinese market. We produced very good machines with many different functions, but our customers did not need them. They need very simple things, for instance those produced by the Japanese or the Taiwanese. [The company's products] were also too expensive, twofold or threefold. I told them so many times. I even sent some prototypes to Germany, but they wanted to stay at a high level [of the market]. Customers want cheaper products, but not very cheap, because the Chinese know that German products are better quality. My recommendation was that we produce top quality for top customers and simpler versions for the middle class. The German management said, "Let's wait a little bit." The result was that after one year, [our] competitors had gained high market shares. (U28)

The conflicts between the two parties originated from the high expectations for expansion in the Chinese market and the unwillingness to change market and production strategies on the German side. For these reasons, the Chinese manager ultimately decided to resign.

The second example comes from a company with Chinese and German management. The technical side was covered by a German manager with experience in Southeast Asia, who reported to a Chinese general sales manager. The German manager was still in the company at the time of the interview, but as the quote below referring to a dispute on market penetration shows, he was clearly stressed by the different expectations from the German and the Chinese sides.

My boss is a Chinese general manager. I also report to the German company, who also wants something from me, and I have to meet the demands of both. It is not that easy. It's like, the German tells me something, the Chinese boss tells me something. There is a small common denominator and there are many external factors that do not fit and you have to solve that somehow. It is not that easy, and I am still conflicted about the whole thing. [...] Business in China is completely different from business in Germany: the German director, who has surely been to China often, expects that I more or less follow German principles, given his scarce knowledge on China. And the Chinese boss, of course, says, "Yes, but we deal with it in another way here." (U26)

The third example comes from a German manager's description of a conversation on production issues between himself and the parent company. The manager had been working for the company in Germany and was sent to China to establish the Chinese subsidiary. Although he was not that prepared for China in advance of his arrival, he was certainly very open to the Chinese environment and culture, as proven by the fact that he learned Chinese and integrated into China well. When he decided to resign, all of his employees followed him, which caused even more difficulties for the German company.

For example, we [needed] a 3-D profile projector, in order to see, measure and read [the value] precisely. The Chinese guy could not get along without it. He doesn't know how to use the calipers, how he has to hold them, how much pressure he has to exert. He does not have the sense of it, he does not understand it. [...] "No, we don't need it. We don't even need it in Germany." Such a thing! "We don't even have it in Germany!" And this is a big problem. If I come to China I cannot build a German company. It does not work. Basically I have to build a Chinese company

with German influence. I can only steer it. I do not have to impose my will and my ways. I have to steer it in such a way that they reach the same results at the end. (U48)

The three examples show how, even with the best plans for management, the managers in the Chinese subsidiary had conflicts with the parent company that resulted from the problems posed by the Chinese institutions and markets. Working without the necessary trust on the side of the parent company even pushed some of the German managers to break the relationship and work instead as regular consultants for companies, rather than reporting to other German SMEs in the future. The Chinese managers, in contrast, mainly decided to apply for other jobs. The experience gained at a German company can raise their value on the market in such a way that they can easily get an even better-paid management position with another company.

German and Chinese managers lament the excessive interference by the parent company in the Chinese subsidiary, claiming that headquarters must trust them blindly and support them. Being in China is not easy, and sometimes it is also frustrating. Managers who are not successful in China are considered by the executives at headquarters to be flops, based on their high expectations and scant knowledge of the country, because “everyone is successful in China.” Those that are successful do not deserve any special reward, because they are, after all, in China.

The interviews show that successful cooperation between the German and the Chinese side occurs when managers in China are left relatively free to operate, and when the German company is very flexible and willing to adapt.

### **Concluding remarks**

The aim of this paper was to explain why, despite growing internationalization processes to China, foreign investments in China encounter difficulties. This paper has suggested that explanations can be found in the way decision-making on internationalization is structurally, culturally and cognitively embedded. In particular, it has suggested that the way these decisions are taken in headquarters has a lasting impact on the performance of subsidiaries.

The structural pressure generated in the supplier chains has a domino effect that pushes companies into making decisions that they would not make voluntarily. Competition is increasingly mediated by hierarchical pressure on competing companies in the supplier chain, rather than being an autonomous mechanism that pushes entrepreneurs to imitate each other on the basis of prices and efficiency. What’s more, internationalization to China appears to resemble the pursuit of a trend: shared models of behavior and conceptions of control become widespread not only because of hierarchical pressure,

but also due to a process of imitation that is based on legitimation, the influence of associations and the positive and uncritical image of China in the media. All in all, these structural and legitimation pressure have pushed companies to go to China.

Company investment in China that is based on structural pressures has been associated with a lack of trust in the subsidiary and an overestimation of the merits of the German way of doing business by the headquarters. If legitimation is the prevailing motivation, entrepreneurs will tend to behave euphorically, to underestimate the challenges of the context. If the decisions are not taken voluntarily, going to China can be perceived as a threat and as a consequence induce rigidities in attitudes and behavior. Entrepreneurs and managers in the headquarters are likely to swallow the bitter pill and invest without looking deeply at the Chinese context and by relying on the own visions of the world and experience. If decisions are taken because of legitimation pressure and because the potential effects of such investments are desirable (wishful thinking), economic actors will also tend to rely only on partial information.

The result is that rather than being based on strategy and flexibility, decisions to internationalize are often characterized by reactive and myopic attitudes, scarce preparation, and the deliberate neglect of information that would contradict the decision-makers' own convictions. This has a negative effect on business performance. Conflicts with subsidiaries and naïve choices during the management recruitment process can end up being very costly and in China even more so. Contrary to general expectations, engaging in China is not easy, and the market for experienced managers is tight.

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