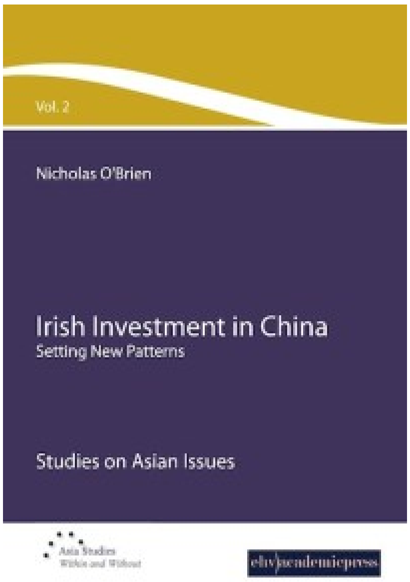
Irish Investment In China. Setting New Patterns ~ Contents, List Of Abbreviations & Glossary Of Terms



Now online: Nicholas O'Brien – Irish Investment in China. Setting new patterns.

Consideration of Irish investment in China will be located within the context of investment theory. Accordingly, *chapter two* examines the seminal literatureon foreign direct investment and sets out an appropriate model of investment theory within which this research shall be considered. The limited literature on Irish outward FDI is also considered, with specific emphasis on Barry et al's model on Irish outward FDI.

Chapter three outlines the results of this research and emerging themes are identified. This allows conclusions to be drawn as to whether Barry et al's model holds in the case of Irish FDI into China. It should be stressed that this is not in any manner a judgement on Barry et al's model. Rather, it is a reflection on the nature of China as an emerging economy and the unique political economy which it enjoys.

Chapter four draws on the research to explore the opportunities and challenges which China represents. The principal locational advantages and disadvantages which China poses are set out. It is argued that the major potential which China represents for Irish investors lies in market opportunity rather than in low labour costs, an opinion which is supported by the relevant literature on FDI in China. The principal locational disadvantages are identified as existing in the regulatory, cultural and legal environments. This allows conclusions to be drawn on our sub-hypothesis, namely the challenges which China poses for investors.

Chapter five explores the nature of Irish FDI into China. The non-application of Barry et al's model to China is discussed together with our prescriptive research question, namely the desirability of state involvement in outward FDI. This chapter also seeks to explain why Irish FDI into China is different from that in the traditional destinations for outward FDI.

The concluding chapter draws on previous chapters to identify conclusions which can be drawn. Key findings are highlighted and potential areas for further research suggested.

List of Abbreviations
China – This term is used to refer to the People's Republic of China

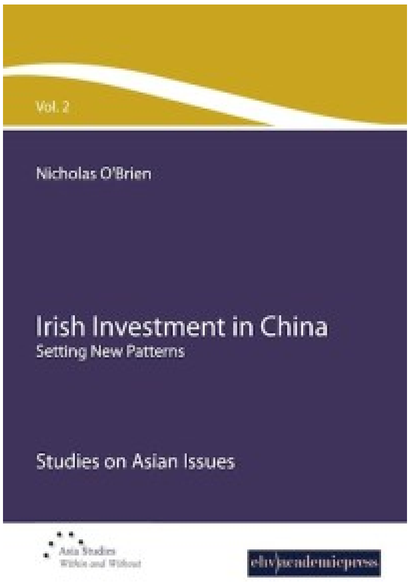
CSO – Central Statistics Office, Ireland
EJV – Equity Joint Venture
EJVL – Equity Joint Venture Law
EU – European Union
FDI – Foreign Direct Investment
HFDI – Horizontal Foreign Direct Investment
IFC – International Finance Corporation
IMF – International Monetary Fund
IPR – Intellectual Property Right
M&A – Merger and Acquisition
MNC – Multinational Corporation
MNE – Multinational Enterprise
NBER – National Bureau of Economic Research
OECD – Organisation for Economic Co-operation and Development
OLI – Dunning's Eclectic Paradigm model: Ownership advantage, Location advantage and Internalisation advantage
SEZ – Special Economic Zone
UNCTAD – United Nations Conference on Trade and Development
US – United States of America
VFDI – Vertical Foreign Direct Investment
WFOE – Wholly Foreign Owned Enterprise
WFOEL – Wholly Foreign Owned Enterprise Licence
WTO – World Trade Organisation

Glossary of terms

Foreign Direct Investment (FDI) – the value of financial flows from 'home' countries to foreign affiliates in 'host' countries, in which a direct investor has a controlling interest.
Host economy – the country that receives FDI from the foreign investor.
Home economy – the country of origin of the investment.
Inward Direct investment – refers to direct investment by foreign investors in the host economy.
Multinational Enterprise – incorporated or unincorporated enterprise comprising parent enterprise and its foreign affiliate(s).
Outward Direct Investment – direct investment by investors from the home economy Pearl River Delta – Hong Kong and its surrounding hinterland.
Subsidiary – an incorporated enterprise in the host country in which the foreign

investor owns at least 50 per cent of the shares or has the right to remove a majority of the board.
Yangtze River Delta – Shanghai and its surrounding hinterland.

Irish Investment in China. Setting New Patterns ~ Abstract & Acknowledgements



Abstract
According to the Industrial Development Path Hypothesis (Dunning, 1981, 1986, 2001), outward Foreign Direct Investment is symptomatic of successful advanced industrialised economies. After a decade of unprecedented growth and prosperity from the mid-1990s, the Irish economy had reached a sufficient level of maturity that Irish firms were beginning to seek new markets in which to invest.

Barry et al's (2003) authoritative work states that Irish outward FDI is disproportionately horizontal and oriented towards non-internationally traded sectors. This study was based exclusively on developed economies – Europe and North America, rather than developing economies or emerging markets. Such countries have not yet featured in the literature on outward Irish FDI. Given the importance of China as the largest global recipient of inward FDI, this book explores the nature of Irish FDI into China and specifically considers whether Barry et al's model on Irish outward FDI holds for current Irish investment into China. This consideration will be conducted within the framework of Dunning's Eclectic Paradigm, which contends that locational, ownership and internalisation advantages must exist for successful investment to occur.

While the level of Irish FDI into China is limited, research was conducted among all Irish firms which had invested in China (this research was conducted in 2006 and 2007). It was found that the nature and scope of Irish FDI into China differs from earlier patterns identified by Barry et al in the case of developed economies. Irish FDI into China is found to be predominately in the traded sector and can be described as only marginally horizontal.

In order to gain a deeper understanding of this development, the locational advantages and disadvantages which China poses are explored. The principal locational advantage is identified as market opportunity. Perhaps the most significant challenge facing investors is the risk to the protection of intellectual property rights (IPR). It is argued that this has the potential to affect the ownership advantage which Irish MNEs possess. Accordingly, there is a need to utilise internalisation advantage to protect IPR. Consideration is given to the role which the state can play in the provision of 'soft supports' for investors, primarily through the provision of market information.

Acknowledgements

The experience and insight offered by senior business executives offered a valuable and unique perspective on the world of private sector decision making. I am particularly grateful for the level of access and openness which I received. I would also like to thank senior staff in the Irish Government state agencies, Enterprise Ireland and the Industrial Development Agency for the valuable information and assistance provided. Without the openness and positive disposition of my interviewees, this research would not have been possible.

I wish to acknowledge the support and encouragement of my doctoral thesis supervisors Dr. Andrew Baker, Queen's University Belfast and Dr. Michael Mulreany, Institute of Public Administration, Dublin. Their guidance and support were particularly important and insightful in helping me develop my line of argumentation. I should also like to acknowledge the support of the Department of Foreign Affairs for their positive attitude and support towards continuing professional education. A special word of thanks is due to the staff at the Department's library, who aided my search for literature in a professional and helpful manner.

Finally, I should like to thank my wife Caroline who, on a snowy afternoon in Monscheau, Germany, suggested that I pursue a doctorate. Together with my

daughters, Ciara and Niamh, she provided support, encouragement and especially the time to facilitate my studies.

Nicolas O' Brien

—

For anybody with an interest in investing in or doing business in China, Nicholas O'Brien's scholarly and informative book should be essential reading. Given the growing importance of China in global trade this is a very timely work which I highly commend.
Dick Spring, former Deputy Prime Minister and Foreign Minister of Ireland

This book identifies clear differences between Irish investment into China and that into traditional FDI locations such as the US and UK. It is an authoritative work, particularly in view of the author's experience as a senior diplomat in China and offers clear conclusions as to the benefits and challenges of investing in China".

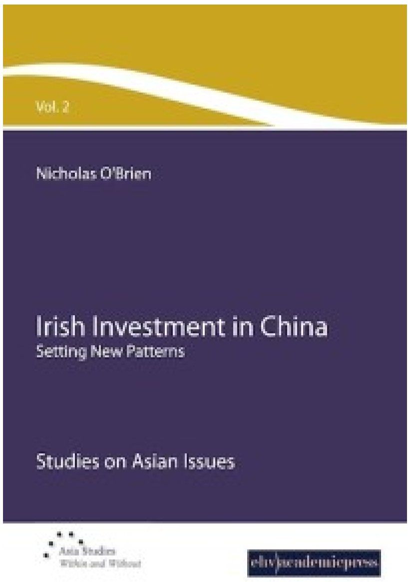
Dr. Michael B. Murphy, President, UCC

This is a must read for Irish people considering investment in China. The author discusses why considerable challenges still remain. A very comprehensive insight into informed investment in China.
Donal O'Callaghan, former Chairperson, Ireland China Association

Dr Nicholas O'Brien worked at the coalface of the transformation of modern China during his four years as Irish Consul General in Shanghai. His work is a testament to intelligent observation and the insight that experienced observers can have. The sideline sometimes brings more perspective than those on the pitch have. His book greatly expands our store of knowledge on this subject in an accessible manner with lucid division of what he is discussing and crystal clear conclusions.
Richard Barrett, Treasury Holdings

This admirable book charts the experience of Irish investors in China and has valuable pointers and good advice for business investors planning to invest in the Middle Kingdom. Given the author's wide international experience, in particular his unique insight as Irish Consul General in Shanghai, this book is an authoritative source on the challenges and opportunities which China offers.

Chapter 1: The Giant Arises ~ Irish Investment in China. Setting New Patterns



Introduction

The introduction of the 'opening-up' policy by the Chinese authorities in 1979 heralded an era of economic reform and 'symbolised China's sharp turn towards participation in the world market to speed to economic growth and technological modernisation'. (Riskin, 1987: 316) Since then, China's economic story has been a remarkable success, growing on average over eight per cent per annum. Central to this economic success was the attraction of inward foreign direct investment. Such was the success of this policy that in 2003 China overtook the US as the largest global recipient of foreign direct investment (FDI), attracting $53 billion in that year (OECD, 2004).

On the other side of the globe, the Irish economy was also going through its own transformation. The 1970s and '80s were a period of high inflation, unemployment and the presence of large-scale emigration. In contrast, the 1990s was an era of unrivalled economic growth, with double digit GNP increases for most of this decade. Central to this transformation was the high level of inward FDI which Ireland attracted. Building on the strength of the economy, outward FDI continued to grow to such a degree that in 2004 Ireland became a net exporter of FDI for the first time.

Given the importance which both inward and outward FDI plays in economic development, the drivers and patterns of Irish FDI into the surging Chinese economy are worthy of examination. Barry et al's (2003) seminal work on Irish outward FDI focuses on FDI into the US and UK, both of which are developed economies. Barry et al show that Irish outward FDI has been disproportionately horizontal (focused on replicating production facilities in third countries rather than moving an entire component of the production chain) and oriented towards non-internationally traded sectors.

Given the importance of China, as the largest recipient of inward FDI and the world's second largest economy, it is opportune to explore the nature of Irish FDI into China and specifically whether or not the model identified for developed economies by Barry et al holds for Irish investment into China. 'As Dunning (1997) has emphasised, full account must be taken of location factors, such as the structure of the host economy, the policies of the host government and the nature of local business culture, in explaining the comparative success and failure of FDI'. (Buckley and Casson, 1998: 27) However, 'China's size makes it different from nearly all other developing and developed countries'. (Eckaus, 1987: 117) It is important therefore for investors, policy makers and commentators on FDI to be conscious of the challenges and opportunities which China holds. While China displays the hallmarks of a market economy, it is a unique political economy. The State is still heavily involved in virtually all facets of economic life. In addition, China has a strong cultural tradition which places an emphasis on relationship building.

The author conducted research into Irish investment during the period 2006-2007 among the relatively small number of Irish investments in China. In the intervening period, the pattern of investment has not appreciably changed and the findings are still valid. The author had the good fortune to witness at first hand the rapid advances which the Chinese economy is experiencing over a four-year period. The rationale motivating this research is the importance of China in the study of FDI and the potential modifications to theory which China may necessitate, because of its status as a developing economy and its non-adherence to the Weberian concept of contract law.

Consideration of the nature of Irish investment in China also generates a sub-hypothesis. The literature review points to the challenges which the business environment poses, including the persistence of guanxi, and what Jones (1994) describes as the Rule of Relationships rather than Rule of Law. Therefore our sub-hypothesis asks if the investment environment in China poses particular challenges for investors who are accustomed to Western norms and if this is a pertinent fact to be considered when evaluating investment decisions. The nature of such challenges and their impact will be explored in order to evaluate whether or not investing in China is particularly different from investing in economies which Irish firms are more accustomed to. If the market is an inefficient allocator of resources, market imperfections are deemed to exist, because additional costs arise. (Mulreany, 1999) Should this be the case, economic theory holds that a role exists for public policy in overcoming such market imperfections.

The engagement or non-engagement of Irish firms in outward FDI is an important economic governance issue. If Irish firms do not engage and their European competitors do so, there is a risk that Irish firms will lose competitive advantage. 'Increased openness to trade and factor flows increases international interdependence with important consequences for governance'. (Barry, 2006: 165)

Research Methodology

In conducting research on Irish investment in China, a combination of quantitative and qualitative research was utilised, with the latter dominating. As a means of obtaining first-hand accounts of the experience of investors in China and the associated challenges, research was conducted among three categories of executives – Irish firms which have invested in China (within the meaning of our definition of investment); selected non-Irish firms which have invested in China; and selected Irish firms which have invested in Eastern Europe. Semi-structured interviews were conducted to establish why they invested in China (or didn't in the case of the latter group) and the challenges which they faced. This data, together with desk-based study, was analysed to allow conclusions to be drawn as to the validity of our primary hypothesis and sub-hypothesis.

As the objective of this research was to establish the perceptions and opinions of key business executives, the relevant data is inherently qualitative rather than quantitative. Quantitative research essentially employs some form of measurement, whereas qualitative research is considered to be the most appropriate form of collecting data on 'experiences and processes – especially as understood by respondents themselves'. (Alcock, 2004: 57) While a qualitative methodology dominated during this research, limited quantitative analysis was also utilised, primarily in the identification of investment trends and patterns, as part of desk-based research. A note of caution needs to be sounded on the availability of reliable statistics on FDI. 'There are gaps in the FDI statistics available from the source and host countries on FDI. Most countries do not publish comprehensive information on the foreign operations of their companies, for reasons of secrecy. Because of these problems, inconsistency between measure of FDI flows and stocks are the rule rather than the exception'. (Moosa, 2002: 2-3)

All Irish companies which have invested in China (with a holding of greater than 50% in their Chinese subsidiary) were selected for inclusion in this research. In the case of non-Irish MNEs which have invested in China, purposeful sampling was employed. The Irish Government's Asia Strategy (Government of Ireland 2006) identifies eight sectors as having the potential to deepen their trade links with China. These industries were identified by the Government because of the strength of their Irish base of operation and as such can be assumed to possess ownership advantage, as described by Dunning, and possibly have the potential to invest in Asia. The eight sectors, as set out in the Asia Strategy, were analysed and four of these sectors were identified as having no Irish firm which has invested in China to date.

Executives of MNEs from these four sectors (telecoms, financial services, education and healthcare) were included in this research in order to identify the experience of investors and relate these findings to the Asia Strategy. A further four MNEs were identified because of the hi-technology nature of their industry, a high susceptibility to intellectual property violation, the strength of the industry in the Irish economy, and a consumer products MNE. In addition, consultations were held with a consultancy company which assists in the setup of MNEs in China, and with representatives of two leading Chinese law firms.

As a means of gaining an understanding of the relatively low number of Irish firms which have invested in China to date, analogous situations were considered to assess if a comparative dimension could be introduced. In the recent past, Eastern Europe was presented as a low-cost, high market-potential destination for FDI. '[EU] Enlargement will also bring forth new investment opportunities for EU15 firms'. (Barry, 2004: 829) One might assume that firms which have already invested in Eastern Europe would also be attracted by the prospect of investing in China, given the strong locational advantages which China offers. Accordingly, a selection of Irish MNEs which have invested in Eastern Europe were selected for inclusion in this research.

The study of the perceptions of business elites on investing in China does not lend itself to a narrow scientific study with its associated definitive findings. Based on the information available on inward FDI into China and the limited information on

Irish outward FDI, a decision was taken to use a qualitative approach through the medium of semi-structured interviews.

The questions around which the semi-structured interviews were conducted were formulated with reference to issues identified during the literature review and areas of specific study in this research. The core research was conducted among executives of MNEs which have invested in China, supplemented by the views of those which have invested in Eastern Europe but not in China.

Outline

Consideration of Irish investment in China will be located within the context of investment theory. Accordingly, chapter two examines the seminal literatureon foreign direct investment and sets out an appropriate model of investment theory within which this research shall be considered. The limited literature on Irish outward FDI is also considered, with specific emphasis on Barry et al's model on Irish outward FDI.

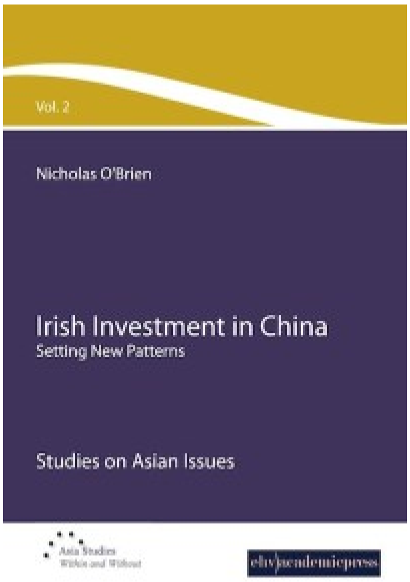
Chapter three outlines the results of this research and emerging themes are identified. This allows conclusions to be drawn as to whether Barry et al's model holds in the case of Irish FDI into China. It should be stressed that this is not in any manner a judgement on Barry et al's model. Rather, it is a reflection on the nature of China as an emerging economy and the unique political economy which it enjoys.

Chapter four draws on the research to explore the opportunities and challenges which China represents. The principal locational advantages and disadvantages which China poses are set out. It is argued that the major potential which China represents for Irish investors lies in market opportunity rather than in low labour costs, an opinion which is supported by the relevant literature on FDI in China. The principal locational disadvantages are identified as existing in the regulatory, cultural and legal environments. This allows conclusions to be drawn on our sub-hypothesis, namely the challenges which China poses for investors.

Chapter five explores the nature of Irish FDI into China. The non-application of Barry et al's model to China is discussed together with our prescriptive research question, namely the desirability of state involvement in outward FDI. This chapter also seeks to explain why Irish FDI into China is different from that in the traditional destinations for outward FDI.

The concluding chapter draws on previous chapters to identify conclusions which can be drawn. Key findings are highlighted and potential areas for further research suggested.

Chapter 2: Literature Review And Issues To Be Addressed ~ Irish Investment In China. Setting New Patterns



Introduction
There is a considerable amount of material on FDI, the multinational enterprise (MNE) and the role of China in today's globalised economy, and the literature considered in this chapter reflects the key issues under discussion. Initially, investment is defined and competing views on investment theory are considered, with the most suitable one for this study identified. Given the inter-twined linkage between FDI and multi-national enterprises (MNEs), the role of MNEs is explored, followed by an analysis of how FDI occurs at the level of the firm.
The limited literature on Irish outward FDI is also set out. Specifically, Barry et al's model on Irish outward FDI is examined, so that the application of their hypothesis to the Chinese economy can be considered. This is followed by a consideration of the rise of FDI in China and the influence which China's unique culture has on the FDI environment.

Investment Defined
The International Monetary Fund (IMF) offers a definition of foreign direct investment.
Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. (The resident entity is the direct investor and the enterprise is the direct investment enterprise.) The lasting interest implies the existence of a long-term relationship between the direct investor and

the enterprise and a significant degree of influence by the investor on the management of the enterprise. (IMF, 1993: 86)
The IMF goes on to define a direct investment enterprise 'as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10% or more of the ordinary shares or voting power'. (IMF, 1993:86) This definition is aimed at providing a standard by which balance-of-payments data is compiled. However, it does not adequately address the issue of control.
The OECD (2006: 2) defines direct investment as a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise). 'Lasting interest' implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise.

Again, this definition is not precise enough for use in this research, as the issue of control is couched in terms of a 'significant degree of influence'. Moosa (2002: 1) comes close to a workable definition when he defines FDI as 'the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country)'.
Lipsey (2001) contends that the United Nations System of National Accounts, which governs the compilation of national income data, appropriately addresses the concept of control. The UN System of National Accounts defines foreign controlled enterprises as subsidiaries of which more than 50% are owned by a foreign parent. (United Nations, 1993) This definition focuses on control and is the one which shall be used as our reference point. Investments below 50 per cent of a firm's stock are either of a portfolio nature or offer the investor a minority shareholding. In seeking to explore potential Irish investment into China and gain a fuller appreciation of the complexities and challenges of FDI, the scope of this research includes only those firms which have a controlling interest. MNEs holding 50% of stock or less are, by their nature, restricted in the scope of their decision-making and influence. 'The distinguishing feature of FDI, in comparison with other forms of international investment, is the element of control over management policy and decision'. (Moosa, 2002: 2)
For the purposes of this research, therefore, control is a central concept. The FDI

relationship consists of a parent enterprise and a foreign affiliate which together form a multinational enterprise (MNE). Given the importance of MNEs and the central role which they play in FDI decisions, their role and structure is explored later in this chapter.

Having set out our working definition of FDI, it is important to distinguish between the two principal forms in which FDI takes place. Firstly firms can invest abroad to supply a market directly through a subsidiary, whereby production processes from the home economy are replicated in the host economy, and this is described as horizontal FDI. This form of FDI is often undertaken to exploit more fully certain monopolistic or oligopolistic advantages, such as patents or differentiated products. (Moosa, 2002) The second form, vertical FDI, is undertaken to locate low-cost locations for components of the production process, whereby certain elements are moved in their totality from the home to the host economy. Horizontal and vertical FDI should not be seen as competing theories. Rather, they seek to explain different rationale underlying investment decisions.

All investments necessarily entail trade-offs and compromises. Horizontal FDI avoids trade costs but foregoes economies of scale, as production is diversified. Vertical FDI incurs the costs of splitting production over various geographic locations. 'Theory suggests factors that are important in these tradeoffs; some of these factors are firm or industry specific (e.g. the importance of economies of scale), some are country characteristics (e.g. the market size or factory prices)'. (Navaretti and Venables, 2004: 127) It would appear that horizontal FDI is by far the major component of outward FDI. Moosa (2002) argues that horizontal FDI may be in the region of 70% of the total. Jim Markusen, one of the leading FDI scholars, states that horizontal exceeds vertical, but acknowledges the difficulty in quantifying this. Reliable data on the breakdown between horizontal and vertical FDI is difficult to obtain. While it can be assumed that horizontal FDI still dominates, the extent of such pre-eminence is unquantifiable.

Having defined FDI for the purposes of this research, it is appropriate to move to a consideration of the body of literature which exists on FDI theory. This literature provides an appropriate investment theory within which to locate our consideration of Barry et al's model and the potential challenges and opportunities facing Irish investors into China.

Dunning's Eclectic Paradigm Investment Theory

Our consideration of Irish outward FDI and its applicability to China should be considered within a framework of investment theory. While there is no universally accepted investment theory, this section will provide an analysis of the framework within which this research is considered.

Investment theories emerged in the post-war period, with the increasing importance of FDI and multinational enterprises (MNEs). Indeed, FDI theories have developed with MNEs at their core. Researchers sought to find theories to explain the actions of MNEs and the expansion of international production. The first such approach was Ohlin's (1933) neo-classical theory, which focused on international trade theory and classic location theory. It was argued that international fund flows are caused by differences between resource endowments among competing countries. Therefore, investment should flow from capital-abundant countries to relatively capital-scarce countries, where higher marginal productivity can be achieved. Interest rate differential is seen as the variable which causes cross-border capital movements, which will cease when the marginal productivity of labour in competing countries is equalised. However, this approach has several defects. It fails to distinguish between direct and portfolio investments, so it does not address the issue of control. (Aliber's (1970) capital-markets approach also fails to incorporate this distinction.) This theory assumes that production technologies are equally well-known in all trading countries and are characterised by constant returns to scale. Also, it is constructed on the premise of a perfect market, which assumes zero transaction costs. (Eckaus, 1987) These assumptions greatly weaken the theory. Perfect competition is a useful theory for economic analysis but rarely exists, if ever. For these reasons, this theory is of limited value in seeking to analyse FDI flows and the motivation of MNEs.
Vernon (1966) developed the product-cycle theory in order to explain the existence of international production as well as international trade. He argued that, as a product moves through its life-cycle, the characteristics of the product will move through three distinct stages, from a newly developed product to a mature product to a standardised product. Each stage has implications for production. In the development stage, production must be located close to markets. During the mature stage, a higher level of capital intensity is required. In the final stage, the standardisation of production means easier imitation and increased competition. Consequently, the firm has to search for low-cost labour in overseas production locations as a means of further reducing unit costs. Vernon's theory was a response to the observation that US firms were among the first to

develop new labour-saving techniques in response to the high cost of skilled labour and a large domestic market. (Du Pont, 2000) This theory proposes that the MNE needs to exploit its firm-specific advantages by moving from its home market to produce overseas in a low-cost location. Vernon made a significant contribution to the development of FDI theory, as he could explain most of the outward FDI from the USA in the 1960s. While this theory holds for some FDI, notably the movement of low-value manufacturing facilities from developed to developing economies, it does not provide an explanation for the flows of FDI between developed economies. Also, the focus on innovation makes it difficult to explain FDI in industries where innovation is not at its core.

Responding to the weaknesses in Ohlin's (1933) neo-classical theory, Hymer (1960) developed the Industrial Organisation theory. Hymer argued that FDI is a result of market imperfections, which can be caused by either the market or government, particularly tariffs and trade barriers. (Mundell (1957) had earlier recognised that FDI develops when trade in goods is impeded.) Hymer went on to argue that companies operating in a foreign country face certain disadvantages in comparison with domestic companies, such as information costs, the business culture, and the political or economic operating environments. Domestic companies are likely to have lower operating costs. Therefore, in order for FDI to occur, foreign companies must have firm-specific advantages which allow them to compete with domestic firms. These advantages, which are of an intangible nature, include superior technology, brand names, financial strength, managerial or marketing skills. It has to be assumed that the firm's intangible advantages are not available to local companies for some time after the foreign firm invests, otherwise the incentive to invest would be negated. Kindleberger (1969) developed this theory further when he argued that the comparative advantage has to be firm-specific, transferable to foreign subsidiaries, and large enough to overcome these disadvantages.

Hymer brought a new dimension to the consideration of FDI, which future researchers built on. Prior to his influential work, it was customary to treat equity investment on a par with capital flows, thereby failing to distinguish between equity and investment flows. (Du Pont, 2000) From a conceptual standpoint he introduced an analysis of the MNE as being central to our understanding of FDI. While Hymer's theory introduces the notion of a spatial dimension it does not address the location advantages which certain economies possess or how the decision to invest is reached by the individual firm. One problem with this approach is that it fails to explain why the firm does not utilise its advantages by producing in the home economy and exporting abroad, which is an alternative to FDI. Even if one accepts the impetus to invest abroad because of lower input costs, Moosa (2002: 32) contends that this theory 'does not explain why firms choose to invest in country A rather than country B'. Hymer's theory does not provide a workable hypothesis for large MNEs which dominate international production. (Du Pont, 2000) Its only acknowledgement of location is that firms may invest in a third country in order to overcome tariffs, but the advantages which a particular location may or may not possess are not considered.

Buckley and Casson (1976) proposed an internalisation theory whose basic hypothesis is that multinational hierarchies represent an alternative mechanism for organising the firm across international boundaries. Firms are likely to engage in FDI whenever they perceive that the net benefits of ownership of foreign subsidiaries exceed those offered by international trading. (Du Pont, 2000) This theory moved away from explaining why an MNE invests abroad to the consideration of why MNEs decide to retain certain activities within the enterprise when undertaking FDI, rather than sub-contracting or licensing production. This approach centres on the logic that the market for intermediate products is difficult to manage and control, so manufacturing can be handled more efficiently within the firm. Therefore, an MNE is created when the firm decides to internalise such production across different markets. Internalisation theory negates the regulatory costs associated with operating in external markets i.e. tariffs can be avoided through local manufacturing. Thus, multinational companies prefer internalising production rather than exporting or licensing as a means of reducing transaction costs. (Williamson, 1985) However, Rugman (1980) argues that the hypothesis underlying this theory cannot be tested directly. Buckley and Casson (1989) acknowledge that statistical tests are bound to be based on simplifying assumptions and lead to the conclusion that the process of internalisation is concentrated where high incidences of R&D occur. While the internalisation theory contributes to the development of a theory of FDI and specifically that of the MNE, it fails to provide a comprehensive approach to the firm's decision to invest abroad, specifically by lacking an analysis of the locational advantages and disadvantages which a particular country can offer. This theory is of use in analysing why MNEs decide to retain production within the firm rather than to sub-contract, and will be of benefit when considering the optimum means of protecting intellectual property rights when investing in China.

While the investment theories cited above make a contribution to our

understanding of investment theory, they focus on partial elements of FDI. Dunning (1979a) built on earlier models of investment and set out a comprehensive explanation of FDI and the MNE. He combined the firm-specific ownership advantage which Hymer had identified with Buckley's internalisation theory, and added a locational dimension. He built on Hymer's hypothesis that for foreign firms to operate in a different environment requires the firm to have a firm-specific advantage which offsets potential disadvantages. Bringing together the strengths of earlier theories, Dunning (1977, 1979a and 1980) provides a conceptual framework in his eclectic paradigm model (also known as OLI Advantage).
Dunning sets out three basic advantages as preconditions for MNEs to successfully undertake FDI: Ownership-specific Advantage, Location-specific Advantage and Internalisation Advantage (OLI). Dunning argues that FDI occurs when these three conditions are met. Ownership-specific advantage is based on the concept that companies possess internal advantages which are specific to the firm and related to the accumulation of intangible assets, such as advanced technology, product differentiation, product innovation, financial strength, marketing expertise or managerial skills. These advantages come in the form of an asset which reduces the firm's production costs and allow it to compete in foreign markets despite the increased costs associated with such a move. As economies have developed and globalisation has intensified, Dunning argues that there is a need for 'firms to undertake FDI to protect, or augment, as well as to exploit, their existing O [ownership] specific advantages'.(Dunning, 2000a: 169) For FDI to occur, the ownership advantages have to be transferable to a foreign country and possible to use simultaneously in more than one location. Dunning's ownership advantage is a restatement and expansion of Hymer's industrial organisation theory. Where Dunning adds to Hymer's theory is with the integration of location and internalisation advantages into one comprehensive model.

Dunning (1979a: 273) states that consideration of the questions associated with the choice of location was "not wholly satisfactory" as this issue has not been integrated with other theoretical approaches. Locational advantage refers to the institutional and productive factors available in a particular geographic area. 'More often, they are related to market characteristics, trade barriers, cost conditions and the institutional and business environment'. (Van Den Bulcke et al, 2003: 13) Locational advantage determines whether or not a particular location is attractive to inward FDI, and a strong locational advantage will reduce the firm's production costs. In the absence of locational advantage, the firm will produce in the home economy and export to the host economy.

Buckley (1989) contends that locational advantage enables MNEs to gain maximum advantage from differential prices of non-tradables in particular locations, particularly labour costs. These advantages are accentuated when they are combined with the inherent strengths of MNEs such as advanced technology, financial strength or marketing expertise. Dunning (2000a) points to the trend that many countries are endeavouring to provide the most appropriate economic and social infrastructure.

…a country or region's comparative advantage, which has been traditionally based on its possession of a unique set of immobile natural resources and capabilities, is now more geared to its ability to offer a distinctive and non-imitable set of location bound created assets, including the presence of indigenous firms with which foreign MNEs might form alliances to complement their own core competencies.(Dunning, 2000a: 178)

Internalisation advantage determines how a firm uses its ownership advantage. In deciding to enter a third country it can decide either to license production to another firm or to establish a manufacturing facility itself. If the firm does not possess internalisation advantage, then it is more profitable for the firm to exploit its ownership advantage by licensing production to an external firm. Internalisation refers to the structure of the firm and its ability to meet the demands of interacting with the market place. Internalisation theory states that as long as the transaction and coordination costs of using external arm's length markets in the exchange of intermediate products, information, technology, marketing techniques etc. exceed those incurred by internal hierarchies, then it will pay a firm to engage in FDI, rather than conclude a licensing or another market related agreement. (Dunning, 2000a: 179)

The reality is that foreign companies incur additional costs as compared with indigenous companies. These extra costs range from a culturally unfamiliar environment to legal and political uncertainties. Internalisation also avoids the difficulty of what Buckley (1987) terms 'buyer uncertainty problem'. This can occur when a firm licences another enterprise to produce its goods. The licensee obtains a transfer of information. Once it has such information, there is a risk that the receiving firm no longer considers that it should continue to pay for it.

FDI occurs only when the firm possesses ownership and internalisation advantages and the host economy offers locational advantage. While possession of ownership advantage is required for a firm to operate in a foreign market, it is the existence of location and internalisation advantages which determines the manner in which the foreign market should be entered. Buckley and Casson (1998) found that all advantages are interconnected. They contend that within these three advantages ownership-specific advantage is the main determinant of why FDI is undertaken; location-specific advantage determines where to undertake FDI; and internalisation advantage determines how FDI should be undertaken. Ietto-Gillies (2005) contends that the strength of Dunning's approach is the contemporaneous analysis of these three variable advantages.

Dunning's contribution to FDI theory is that he provides a comprehensive framework for discussion of the motives underlying FDI. 'The eclectic paradigm was developed by Dunning by integrating the industrial organisation hypothesis, the internalisation hypothesis and the location hypothesis'. (Moosa, 2002: 36) He also explains the choice of entry into foreign markets. The strength of Dunning's model, as compared with earlier theories, is that it offers an inclusive and complete framework within which to analyse FDI and the role of the MNE.

This being said, Dunning has his critics. Ietto-Gillies (2005) argues that the original eclectic paradigm hypothesis is too wide to be useful in practice, with at least 20 possible ownership advantages, 11 internalisation advantages and 16 locational advantages to be considered. In later works Dunning acknowledges the difficulties which the number of variables can pose and uses terms such as 'systemic framework' or 'paradigm' rather than 'theory'. 'The eclectic paradigm is more to be regarded as a framework for analysing the determinants of international production than as a predictive theory of the multinational firm'. (Dunning, 2000b: 126) Dunning suggests that the key to operationalising his paradigm lies in contextualising the variables e.g. the contextualisation of the ownership advantage can be achieved by reference to the kind of multinational enterprise which is most appropriate to the activity, be it resource seeking, market seeking, efficiency seeking or asset seeking.

Dunning's framework commands strong support within international business theorists. 'Any conference on international business is likely to have a number of papers using Dunning's framework. It has certainly been successful in introducing the taxonomy of OLI advantages'. (Ietto-Gillies, 2005: 117) 'A striking feature of this [FDI] literature is its overwhelming reliance on the OLIparadigm framework'. (Du Pont, 2000: 21) Ietto-Giles accepts that the strongest point of Dunning's approach is that he highlights how internationalisation and locational issues are interlinked. This means that issues specific to firms and their competitive advantages must be seen in conjunction with issues related to local conditions and to issues of markets and industrial organisation.

Given the diversity of opinion within academic writing, there is unlikely to be consensus on the most appropriate theory to explain FDI. ‘There is not one but a number of competing theories with varying degrees of power to explain FDI’. (Agarwal, 1980: 740) Most theories of FDI are under-determined and deal only partly with observed trends. (Du Pont, 2000) However, Dunning provides a framework within which to evaluate both the firm and the location chosen for FDI. Other theories consider these aspects in isolation. Du Pont (2000: 14), while a keen supporter of Hymer’s approach, acknowledges that:
Dunning offers a rich conceptual framework for explaining not only the level, form and growth of MNC activity, but also the way in which such activity is organised. Furthermore, the paradigm offers a robust tool for analysing the role of FDI as an engine of growth and development as well as for evaluating the extent to which the policies of source and host governments are likely both to affect and be affected by that activity.

In response to criticism that the eclectic paradigm is a static rather than dynamic analysis, Dunning developed the Investment Development Path (IDP) hypothesis:
The basic hypothesis of the IDP is that as a country develops, the configuration of the OLI advantages facing foreign-owned firms that might invest in that country, and that of its own firms that might invest overseas, undergoes change, and that it is possible to identify both the conditions making for the change and their effect on the trajectory of the country’s development. (Dunning, 2001: 180)

The IDP hypothesis ‘proposes that there is a U-shaped relationship between economic development and a country’s net outward investment position’. (Barry et al, 2003: 342) The IDP identifies five stages of development through which a country will pass. The first stage is one of pre-industrialisation, when a country has little or no inward or outward FDI because it does not possess sufficient locational advantages. As government policy develops or natural resources are exploited, the first wave of inward FDI will concentrate on the natural resource sectors, labour intensive industries, construction and possibly tourism. ‘Depending on the extent to which the country is able to create a satisfactory legal system, commercial infrastructure and business culture, and to provide the business sector with the transport and communication facilities and human resources they need; and depending on its government policy towards inward direct investment, its locational attractiveness will increase’. (Dunning, 2001: 181) This second stage sees the development of some location specific advantages which leads to inward FDI targeting the emerging domestic market in consumer goods and infrastructure.

The improvement in the locational advantage of a country may help indigenous firms to upgrade their own ownership advantage. As countries move along their development path, the OLI configuration facing outward and inward investors continues to change. Some foreign (and domestic) firms, which earlier found a country attractive to invest in because of its low labour costs or plentiful natural resources, no longer do so. In other cases its L [locational] advantages have become more attractive as an indigenous technological infrastructure and pool of skilled labour is built up. This, in turn, makes it possible for domestic firms to develop their own O [ownership] advantages and begin exporting capital. (Dunning, 2001: 181)

Stage three witnesses a modest rate of growth in inward FDI, which is eventually overtaken by outward FDI. The fourth stage sees the country become a net outward investor with location advantage based on created assets and indigenous firms’ ownership advantage. Dunning contends that whether this happens or not depends on the strategy of individual firms and the policies of national governments to generate the competitive advantage of domestic firms and by making the location attractive to both domestic and foreign investors.

The final stage sees the net FDI flow position approaching zero with permanently high stocks of both inward and outward FDI. The net FDI flow position will be determined by short-term trends related to exchange rates and economic cycles. Dunning and Narula (1996) argue that this stage of development has been reached by the more advanced industrialised economies, whose wealth creation and productivity growth are increasingly based on the ability to utilise intellectual capital. It is possible to identify the Irish investment experience in several of the stages identified by Dunning. We shall return to this below when we consider the composition of Irish outward FDI.

Dunning sets out a theory which is broadly accepted internationally, and which provides a strong analytical framework in which to locate this research. No other theory offers such a holistic and dynamic approach or can so adequately encompass the characteristics of the firm and the specific attributes of the location chosen for inward FDI. For this reason, it is chosen as the framework for the analysis in which the nature and scope of Irish outward FDI into China is explored.

The Role of the Multinational Enterprise in FDI

It was the attempt to explain the actions of MNEs and the expansion of international production which led to the development of FDI theory. Indeed, FDI and MNEs are so intertwined that the motivation for FDI may be used to distinguish between MNEs and other firms. (Moosa, 2002) An understanding of why investment by a foreign firm differs from that made by a domestic firm assists in our appreciating the dynamics which underlie FDI. As FDI entails higher costs for the investing firm, MNEs must possess an advantage over local firms sufficient to offset the costs of international coordination, or the locational benefits will be captured instead by indigenous firms. (Froot, 1993) FDI has been described as the highest commitment a firm can make in international business as it involves not only the infusion of capital but also the transfer of personnel and technology. (Daniels and Radebaugh, 1995) Research in the areas of MNEs and FDI provides a theoretical underpinning which suggests that the MNEs' ability to organise their unique, firm-specific assets and resources over many countries and exploit the advantages of operating in these countries fundamentally alters their approach to business, the nature of their assets and resources, and accordingly the impact they have on host countries. (Scott-kennel, 2004)

In seeking to understand the role of MNEs, Hymer 'is regarded as a seminal figure in the establishment of the theory of the multinational enterprise'.**[i]** (Buckley, 2006: 140) Hymer clearly distinguished between portfolio and direct investment, with the latter offering managerial control.

Hymer focused on the specific advantages which the firm possesses, which enable it to engage in outward FDI. Hymer borrowed D.H. Robertson's description of MNEs as 'islands of conscious power in an ocean of unconscious co-operation'. (Hymer, 1970: 441) He forecast that increasing specialisation by MNEs would force the global economy to become spatially specialised with a hierarchy of specialised locations emerging. However, Graham (2006) points to Hymer's lack of success in arriving at a dynamic model of the MNE. Buckley and Casson (1998) argue that there is a need for a new agenda in models of the MNE based on dynamic analysis and a move away from Hymer's static analysis. Such a new agenda 'highlights the uncertainty that is generated by volatility in the

international business environment. To cope with flexibility, corporate strategies have to be flexible'. (Buckley and Casson, 1998: 22)
Navaretti and Venables (2004) see such a dynamic existing in Dunning's eclectic paradigm. In analysing Dunning's work they outline three defining questions underlying a firm's decision to internationalise – what are the costs and benefits to the firm of splitting production; whether the firm's foreign activities should be internal to the firm or outsourced to independent operators; and what are the effects of multinational activity on the home and host countries. These three issues are now examined in turn.

The decision on whether to concentrate production in a single country or disperse it across several countries has associated costs and benefits. The cost of splitting off production to a third country also entails costs in terms of the efficient use of factors of production. Multinationality is most likely to occur when there are high firm-scale economies, combined with relatively low plantscale economies. Navaretti and Venables (2004) argue that the gain in market power will be even greater if the investment takes the form of a merger or acquisition, which directly eliminates a potential rival. 'Market power considerations are a major motivation behind both domestic and international M&A activity'. (Navaretti and Venables, 2004: 28) But this form of market entry poses particular challenges in China, a matter we shall return to later.
A perceived benefit of investing abroad is the incentive to reduce production costs.

MNEs will gain from moving unskilled labour-intensive activities to countries where unskilled wages are low, R&D-intensive activities to places where scientists are relatively cheap and so on. The expansion of EU investments in Central and Eastern Europe countries, US investments in Mexico, and the investments in software companies in Bangalore are all driven by the aim of reducing costs of production.(Navaretti and Venables, 2004: 29)

They qualify this statement by pointing out that factor prices have to be adjusted for the quality of the factor input. 'The evidence suggests that FDI rarely goes to the lowest-wage economies, going in preference to countries that have abundant labour with basic education… Firms look at the cost of labour, not its abundance'. (Navaretti and Venables, 2004: 29)

From an organisational perspective, FDI is a choice to retain functions internally within the firm rather than relying on other actors in the market. There is also the option of licensing the franchising. There are costs and benefits associated with retaining the function internally or relying on market transactions. 'Internalising may bring a direct cost penalty, but avoids problems of contractual incompleteness in dealing with outside agents'. (Navaretti and Venables, 2004: 25) Internalising production also has the advantage of better protecting one's intellectual property. The protection of intellectual property is an on-going challenge in the Chinese economy, an issue which will be considered in chapter four.

The decision to internationalise one's production has an effect on both the host and the home economies. Navaretti and Venables (2004) identify three channels through which the effects on host (receiving) and home (sending) countries are transmitted: product market effects, factor market effects and 'spillover effects'. In the case of product market effects, the firm undertaking FDI will change the quantity of goods it buys and sells in the host and home country when it undertakes FDI. In the case of substitute products in the host economy, local firms may be unable to sell as much produce as heretofore and crowding-out can occur. Consequently, consumers may not be any better off and local firms may be forced to sell less or perhaps leave the market. Alternatively, the MNE may increase competition in the marketplace and perhaps also increase quality or variety, which will subsequently raise consumer welfare. If the MNE has higher productivity than local enterprises, then consumers may see a price reduction.

Factor market effects can occur in both labour and capital markets. In general, when a MNE sets up in a host country, there is an inflow of funds. It is not normal practice to raise the funds on the local market (this is a pertinent issue in the construction sector in China, an issue that we will return to, given the strength of this sector in traditional Irish outward FDI). In the case of the labour market, a range of situations may occur. The demand for different categories of labour will increase in the host economy and may fall in the home economy, depending on the type of investment undertaken. The establishment of an MNE may also have an impact on skilled labour in both economies. If the jobs being established in the host economy require a certain degree of skill and such skill is in short supply, then wage levels will increase as employees move between companies. This phenomenon is currently evident among English-speaking educated Chinese executives, for whom there is an ever-increasing demand, particularly in areas such as Shanghai and Guandong. As stated above, this issue features in our research.

It is argued that the most important benefits to accrue from FDI are a variety of 'spillovers', which may be technological or pecuniary externalities. The former arise when FDI imposes costs or benefits that are not directly transmitted through markets. The latter arise when effects transmitted through markets are not fully paid for, so parties to the transaction may receive economic surplus. (Navaretti and Venables, 2004: 41) Technological externalities include technology transfer and the acquisition of labour skills. 'It [FDI] can bring not only capital but also new technologies and skills that might not otherwise be obtainable'. (Eckaus, 1987: 127) Technological changes have not simply altered the ways in which firms conduct their overseas business activities, but they have made possible the creation of a new infrastructure for carrying out diverse operations within a unified structure. (Du Pont, 2000) The insistence of the Chinese authorities on obtaining a transfer of technology through FDI will be considered during our research. Also considered will be the potential impact which this has for firms seeking to protect intellectual property rights.

… the overwhelming evidence for MNEs both operating abroad (foreign subsidiaries) and at home (headquarters and home plants) is that they perform better than fully national firms… The analysis of firm-level data for the UK, the US, Italy and various other developed and developing countries reports that average labour productivity in foreign subsidiaries of MNEs is between 30% and 70% higher than in national firms and for the home activities of MNEs it is approximately 30% higher'. (Navaretti and Venables, 2004: 42)

MNEs do not perform better simply because they are multinational players. They are larger in scale, engage in R&D, use more capital and generally employ more skilled labour. Vaupel (1971) compared US MNEs as with domestic US firms. He found that MNEs incurred higher R&D expenditure, had higher net profits, had higher average sales, paid higher wages in the US, and had a higher export/sales ratio. Using an econometric model, Grubaugh (1987) obtained results supporting the importance of R&D, product diversity and size as characteristics of MNEs. The emphasis on R&D confirms the link with Dunning's ownership advantage. By pursuing R&D, the firm increases its internal advantage and affords itself higher levels of technology than its rivals.

Policy makers should be reassured by the evidence that when a national firm transfers part of its production to cheap-labour countries or is bought out by foreign investors, its performance is generally better than if the firm had not

invested abroad or had stayed national. Moreover, MNEs often have features (size, R&D, investments, brands etc.) that national firms do not have and which in themselves are important, as they enrich the domestic production structure and they improve its average performance. (Navaretti and Venables, 2004: 43)
This is an important consideration and one which we shall return to in chapter five, during our discussion of public policy on outward FDI.

Why FDI Occurs?
Dunning offers a theoretical framework within which investment occurs and which will guide the consideration of our hypothesis. However, it is also important to explore the specific motivation which leads to the individual firm's investing in a third country.
Hewko (2002) argues that if a country offers significant business opportunities and does not present any formal barriers to investment it will attract foreign investment. As the market size grows to a critical value, FDI will start to increase with further expansion. Navaretti and Venables (2004: 141) contend that 'the larger the host market the greater the likelihood that MNEs will be able to recoup the fixed cost of their foreign plants'. Secondly, a stable political and social environment is conducive to the attraction of FDI. Conversely, large and unexpected modifications of legal and fiscal frameworks may drastically change the economic outcome of a given investment.
Studies indicate that the effect of labour cost on FDI is controversial. Goldberg (1972), Saunders (1983), Schneider and Frey (1985), Culem (1988) and Moore (1993) found that a rise in the host country's wage rate would discourage FDI. On the other hand, Nankani (1979), Kravis and Lipsey (1988) and Wheeler and Mody (1990) found the opposite. A possible explanation for these conflicting results is offered by Lucas (1993), who shows that a rise in the wage rate of the host country means an increase in the costs of production, which should discourage production and consequently inward FDI. However, the increase in wage levels may cause a movement to more capital-intensive means of production, which may result in higher inward FDI. It is fair to assume that in the case of low-skill, high-volume manufacturing, labour costs are an important determining factor. However, as companies increase the value of their output, skill levels increase and the manufacturing process becomes more complex. Quality skilled labour is then likely to assume a higher degree of importance, with less emphasis on labour costs. Navaretti and Venables (2004: 140) contend that the reason for the mixed results is because of the need to differentiate between horizontal and vertical

FDI. '[W]e expect VFDI to increase with differences in factor endowments and factor costs, as this is precisely what investors are looking for'. Reuber et al (1973) assert that low labour costs in developing countries provide the basis for high rates of return on export-oriented products. This assertion will be examined later in the case of China, specifically in the case of Irish FDI into China.

A country's degree of openness to international trade should have a direct relationship to the level of FDI. Kravis and Lipsey (1988) report a strong positive effect of openness on FDI. Wheeler & Mody (1992) observed strong evidence in the manufacturing sector, but a weak negative link in the electronics sector. This points to the lack of homogeneity in FDI. There are various submarkets for FDI depending on the level of skill, value of output etc. This issue will be revisited when determining which sectors of the Irish economy hold the most potential in terms of inward FDI into China. Allied to this is the question of tariffs.

Studies find that tariff jumping is an important motive for investments in the US and EU. For example, Barrell and Pain (1999b) examine the determinants of aggregate flows of Japanese FDI into both the European Union and US in the 1980s. They find that Japanese FDI into a particular country is strongly influenced by the extent of that country's trade protection measures and, in particular, by its extent of antidumping activities.' (Navaretti and Venables, 2004: 137) Countries that are more open to trade tend to provide and receive higher levels of FDI. (Lipsey, 2000) Bajo-Rubio and Sosvilla-Rivero (1994) found a significant effect of the tariff rate on FDI. Indeed, Blonigen and Feenstra (1996) suggest that FDI may be induced by the threat to introduce protectionist measures. A further consideration is the relative strength or weakness of the host economy's currency. The weaker the currency of a country, the less likely are foreign firms to invest in that location. This is because an income stream from a country with a weak currency is associated with exchange rate risk, and an income stream is therefore capitalised at a higher rate by the market when it is owned by a weak currency firm. Chakrabarti (2003) states that a strong currency is often interpreted as an indication of the greater competitiveness of the host country.

Intercultural transaction costs are inevitable when cultures meet. They are produced by mistrust, miscommunication, language difficulties, clashing values, conflicting senses of propriety etc. Prejudice or ignorance may distort the investor's perception of the foreign market. The host-country consumer may have a disdain for goods made by a particular country. Cultural compatibility can

enhance a destination for foreign investors, but cultural estrangement can nullify the attractiveness. The importance of Chinese culture will be considered further in this chapter, given its strong influence in Chinese society.
Another consideration is the efficiency and transparency of the legal system. A transparent legal system reduces transaction costs for economic actors and is of considerable benefit in attracting FDI. Needless to say, an arbitrary legal system will be relatively uninviting for investors. In the latter case, there may be some investors who are willing to invest on the basis of very high potential returns, but generally investors require legal certainty.
Finally, most governments adopt policies aimed at encouraging inward FDI by offering incentives. Moosa (2002) identifies the incentives which governments offer as tax reductions, exemption from customs duties, accelerated depreciation, grants, loan guarantees, market preference (including monopoly rights) and low cost infrastructure. The effect of incentives in successfully attracting FDI is far from clear. It is arguable that incentives benefit a firm which would have made the investment in any event. The results of Agarwal's (1980) empirical studies show that incentives have a limited effect on the level of FDI, as investors base their decision on risk and return considerations. Reuber at al (1973) found that incentives can play a role in encouraging small firms with limited experience, but their overall impact is small.

Views diverge on the effect of taxation on FDI. 'Hines (1999), in his survey of empirical studies, concludes that "the econometric work of the last 15 years provides ample evidence on the sensitivity of the level and location of FDI to tax treatments"…. There is also evidence that responsiveness to tax has increased in recent years, as might be expected if VFDI, which is not tied to serving a particular market, has increased in importance'. (Navaretti and Venables, 2004: 139) Buckley (1987) argues that the urge to avail oneself of transfer price manipulations may induce a bias towards low tax countries. Devereux and Griffith (1998) contend that differences in taxation policies have an impact once the decision to invest overseas has already been made, but not in the making of the decision itself. Newman and Sullivan (1988) conclude that the modelling and estimation limitations of existing studies make it difficult to reject the hypothesis that taxes influence business location, but the results are not clear. The views of commentators on the effect of taxation are mixed. Taxation is part of a package of measures which investors find attractive. It is the overall environment of a particular country, as constituted by its political, social and economic conditions, which attracts FDI. (Moosa, 2002) Common determinants of FDI emerge from the above literature: market size, labour costs, trade barriers, the growth rate, openness, the exchange rate, political certainty, culture shock, the legal system and business opportunities. Theoretically, the size of the host market, low labour costs, fiscal incentives, a favourable business climate, and trade openness should have positive impacts on FDI, while high transportation costs, bureaucratic red tape, and political instability should act as disincentives. *Table 1* gives some useful pointers in determining the likelihood of whether a firm will invest in a particular country or not.

Table 1: Determinants of FDI: Theoretical Predictions

Determinants	Prediction by type of investment Horizontal	Vertical
Determinants relating to types of firms or industries		
Firm-level economies of scale	+	+
Plant-level economies of scale	-	?
Production-specific trade costs	+	-
Difference in factor intensity between stages of production	?	+
Determinants relating to type of country		
Trade costs (distance, trade barriers etc.)	+	-
Market size	+	?
Factor cost differentials	?	+

Source: Navaretti and Venables (2004: 31)

Table 1: Determinants of FDI: Theoretical Predictions
Source: Navaretti and Venables (2004: 31)

These factors should be borne in mind when considering the determinants relating to which sectors of the Irish economy should focus their attention on China. Vertical FDI is likely to occur when factor cost savings are large relative to the costs of fragmenting activities in two or more locations. The table shows a clear prediction in the case of horizontal FDI and market potential. This will emerge as one of the key rationale for Irish firms investing in China.

Having set out the theoretical framework within which this research will be conducted and the role of MNEs in today's globalised economy, the literature on Irish outward FDI is now considered.

Irish Outward FDI

By way of introduction, it is important to point out that there is a limited amount of literature on Irish outward FDI. While Forfás, the Irish Government's national policy and advisory board for enterprise, trade, science and technology, has conducted one study on Irish outward FDI, the key published work in mainstream academic journals is Barry et al (2003). Both Barry et al's and Forfás' analyses have focussed on the US and UK as a destination for outward FDI. The findings of a survey undertaken by the Irish Business and Employers Federation (IBEC, 2006) on trade and investment with Asia will also be considered. While most of the data refers to trade, some interesting observations are made on investing in China. In addition, the perceptions of firms on trade issues may be of benefit in corroborating the findings of this research e.g. in the domain of intellectual property rights.

Forfás (2001) refers to Ireland's successful track record in attracting inward FDI. It also acknowledges the growing trend of outward FDI by Irish multinationals but points to the absence of analysis of this issue. It points out that traditionally the bulk of Irish FDI outflows came from a relatively small number of Irish firms. 'While these "old economy" firms still dominate the stock of Irish-owned direct investment assets overseas, a small number of "new economy" high-technology firms have recently started to make significant overseas investments' (Forfás, 2001: 4).

Forfás (2001) alludes to the lack of statistical data on Irish outward FDI. There are three reference sources, the Central Statistics Office (CSO), Eurostat and the UN Conference on Trade and Development (UNCTAD). However, both UNCTAD and Eurostat source their data from the CSO. The information available is limited and does not provide a comprehensive time-series on Irish outward direct investment flows and stocks by sector of origin or country of destination. Accepting this caveat, an analysis of the data for recent years points to an interesting change in patterns in Irish investment.

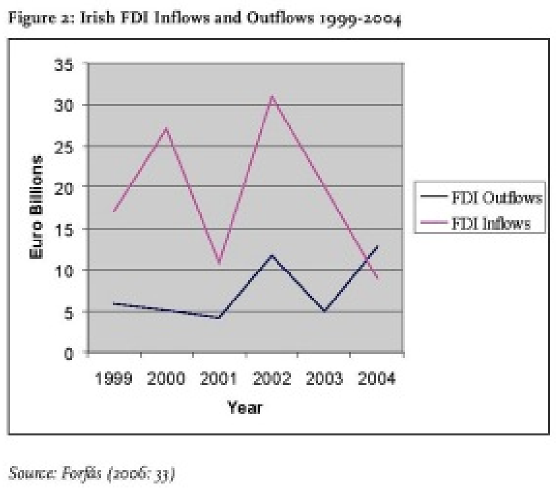


Figure 2: Irish FDI Inflows and

Outflows 1999-2004
Source: Forfás (2006: 33)

The most interesting data available is the significant change in FDI flows since 2001. FDI outflows have increased significantly since 2001, and in 2004 were the largest ever recorded at € 12.7 billion. (Forfás, 2006) *Figure 2* gives a representation of the changing trends in Irish FDI.

This graph identifies a sharp decline in inward FDI and a gradual increase in outflows.

Ireland was previously characterised by exceptionally high inflows and average outflows for a developed country. The trends of 2004 may signal a departure from this trend. Inflows of € 9.1 billion in 2004 represented a sharp decline from the peak of € 31.2 billion achieved in 2002, even though inflows still remain high relative to other similar countries. Much of this decline was due to particularly large repatriation of profits by multinationals in 2004. This trend is likely to continue in 2005 and 2006, as changes to US tax law subject earnings by US companies based in Ireland to considerably lower tax rates. (Forfás, 2006: 39)
We can say that an important milestone was reached in 2004 when outflows exceeded inflows for the first time by € 3.6 billion. (CSO, 2006) Barry et al (2003) have examined this trend and argue that it provides evidence of Ireland's conforming to Dunning's IDP hypothesis.

The cumulative Irish stock of FDI invested abroad is estimated to be € 61 billion in 2004. This is equal to 41% of GDP, which is similar to the ratio for the EU-15 as a whole. (Forfás, 2006) However, three years earlier Forfás (2001) pointed out that the ratio of stock of outward FDI to the stock of inward FDI was lower in Ireland than in any other advanced economy and was significantly lower than in most other small EU countries. 'Ireland's rather unique direct investment relationship with the rest of the world reflects not only the high levels of inward investment into Ireland compared with other advanced countries, but also very low levels of outward investment flows from Ireland'. (Forfás, 2001: 8)
The low levels of outward FDI reflect a number of historical factors. With the exception of financial services, Ireland has few large indigenous firms in the industries that generally generate the bulk of global FDI flows, such as oil, cars, telecommunications, electronics and pharmaceuticals. 'Other factors included Ireland's relatively recent industrialisation, the historically heavy focus of

development policy on inward investment, and the more active promotion and facilitation of outward investment by other EU governments'. (Forfás, 2001: 10)

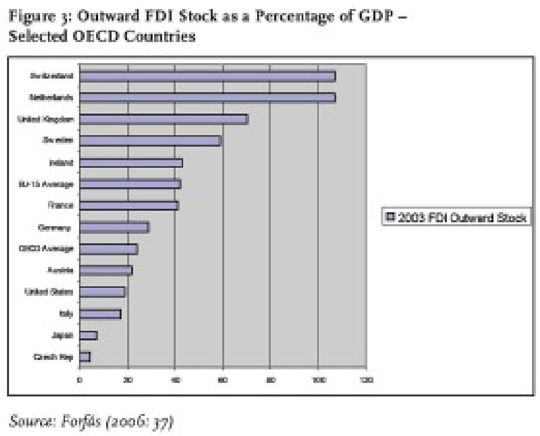


Figure 3: Outward FDI Stock as a Percentage of GDP – Selected OECD Countries
Source: Forfás (2006: 37)

Detailed official statistics are not available on the destination of Irish outward FDI. The most informative information available is provided by LOCOmonitor (2006), a global database that tracks greenfield projects internationally and identifies 212 instances of Irish outward FDI in the period 2002 to 2006 (two months only). *Table 2* sets out the regional destination of Irish outward FDI.

This data should be treated with caution as it relates to Greenfield investments only and does not include mergers and acquisitions (M&A). Accepting this caveat, this data shows that the most important destinations for Irish outward FDI are Western and Eastern Europe and North America. 'Within Western Europe, FDI to the United Kingdom is by far the most important destination, accounting for two-thirds of Irish FDI to Europe… It is also notable that Asia, including developed countries such as Japan and developing countries like China, attracted less than 10% of Irish FDI projects in the period 2002-2006'. (O'Toole, 2007:392) A detailed breakdown by country is not available, but the provision of such information in future years would add greatly to our ability to analyse outward FDI flows.

Barry's model on Irish outward FDI
As set out above, the Investment Development Path (IDP) hypothesis proposes that the changing pattern in FDI flows is systematically related to a country's

level of economic development. With increasing economic prosperity, a country evolves from being a net recipient of investment to being a net outward investor. Barry et al (2003) contend that Ireland is an interesting IDP test case because of its rapid economic development and the heavy reliance of Ireland on inward FDI as compared with other EU countries. They examine if, given the magnitude of inward FDI, the pattern predicted by the IDP concept is realised. Pointing to the unavailability of time-series data over a considerable period on outward FDI flows, they show that Ireland in the late 1990s had the third largest stock of inward FDI in the EU, after Belgium/Luxembourg and the Netherlands**[ii]**. On the other hand, Ireland's stock of outward investment was the third lowest. 'This suggests that until recently outward FDI flows from Ireland were not very large, as the IDP concept would suggest'. (Barry et al, 2003: 342)

While acknowledging the lack of consistent time-series data on outflows from Ireland, Barry et al (2003) argue that there is evidence of increasing outflows, which is consistent with the Investment Development Path hypothesis. Using CSO data and material from the US Department of Commerce (the only source of a comprehensive time-series on both FDI inflows and outflows by nationality), Barry et al (2003) point out that Irish FDI into the US grew more rapidly than US FDI into Ireland in the 1980s and 1990s, to such a degree that they were broadly similar by the end of the 1990s. Their analysis of US data 'provide[s] evidence of a U-shaped relationship between Irish GDP and the country's net outward FDI position with the US, a pattern consistent with the IDP concept'. (Barry et al, 2003: 345)

Table 2: Regional Destination of Irish Outward FDI

	2002		2003		2004		2005		2006 (Jan-Feb)		2002-2006	
Region	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Africa	1	2.0	2	4.3	2	4.3	1	1.7	-	-	6	3
Developed Asia	2	3.9	-	-	2	4.3	2	3.4	-	-	6	3
Europe	34	66.7	25	54.3	21	45.7	36	61.0	7	70.0	123	58
Developing Asia	2	3.9	5	10.9	2	4.3	4	6.8	-	-	13	6
Eastern Europe	4	7.8	3	6.5	13	28.3	10	16.9	1	10.0	31	15
Latin America	1	2.0	2	4.3	2	4.3	2	3.4	-	-	7	3
Middle East	-	-	2	4.3	1	2.2	-	-	-	-	3	1
North America	7	13.7	7	15.2	3	6.5	4	6.8	2	20.0	23	11
TOTAL	51	100	46	100	46	100	59	100	10	100	212	100

Source: O'Toole (2007: 393)

Table 2: Regional Destination of Irish
Outward FDI
Source: O'Toole (2007: 393)

While the IDP concept is silent on the distinction between vertical and horizontal

FDI, Barry et al (2003) predict that as production costs rise there is an incentive for domestic firms to engage in vertical FDI, moving labour-intensive components to countries with a locational advantage in low-cost labour.

Later in the process, firms are able to compete in overseas markets and so engage in horizontal FDI. The incentive for horizontal outward FDI may develop as the economy becomes wealthier and domestic firms seek to maintain their competitiveness. (Barry et al, 2003) Also, economic development results in rising labour costs in the home economy, leading to a reduction in inward investment flows, and creates an incentive to engage in vertical FDI.

Turning to the composition of Irish outward FDI, Barry et al (2003: 345) analyse the available global data on the sectoral destination of Irish acquisitions overseas and identify that “the bulk of Irish outward FDI is of the horizontal type.” They also point out that outward FDI is predominately in non-traded sectors. Their work is a valuable and important contribution to our understanding of Irish outward FDI as it identifies the nature and composition of Irish FDI in the case of the largest markets in which Irish investment is made, i.e. the UK and US. This research, which focuses exclusively on China, adds further to our knowledge as it is examines Irish outward FDI to a developing economy.

Table 3 sets out the sectoral distribution of overseas acquisitions in the US by EU firms, by all countries and by Irish firms. **[iii]**

The second column shows the sectoral composition of acquisitions by all overseas firms in the US. Data for this group is broadly similar to that for acquisitions by EU firms, with the exception of the financial services sector, which has a greater dominance among EU acquisitions. What is striking is the divergence of Irish acquisitions from these two groups. The most important sectors for Irish acquisitions are financial services;

Table 3: US M&A activity by sector, average annual share1993-99:
(1) by EU firms; (2) within the US; and (3) by Irish Firms

Sector	Cross-border M&A by EU firms	Cross-border M&A by all firms	Cross-border M&A by Irish firms
Food, drink and agribusiness	5.9	5.7	17.5
Print, paper and publishing	2.8	4.5	16.2
IT, Telecoms and electronics	5.1	7.8	4.0
Chemical and Pharmaceuticals	14.4	17.0	9.5
Other manufacturing	24.2	20.5	5.8
Construction, property	1.0	1.8	22.2
Financial Services	32.4	22.5	22.5
Services (consulting, retail etc)	14.3	20.2	2.0
Total	100.0	100.0	100.0

Source: Barry et al (2003: 345)

Table 3: US M&A activity by sector, average annual share1993-99: (1) by EU firms; (2) within the US; and (3) by Irish Firms
Source: Barry et al (2003: 345)

construction; food, drink and agribusiness; and print, paper and publishing. The result for the financial service sector is broadly in line with the data for all investment in the US, approximately ten per cent below the EU data. Barry et al (2003) point out that as the food, drink and agribusiness sector accounts for 27% of Irish manufacturing employment compared to 12% within the EU15, the result for this sector is not greatly surprising. However, the figure for the construction sector is notable and reflects the traditional strength of this sector in the Irish economy with outward FDI having a historical basis. ‘Expansion abroad in such largely nontradable sectors entails horizontal rather than vertical FDI. If companies in these sectors expand abroad they do so for market-access reasons i.e. in order to penetrate and grow in new markets’. (Barry et al, 2003: 345)

Barry et al (2003) point to a large increase in 2000 by Irish firms in hi-tech sectors such as information technology and the pharmaceutical industry. The IDP concept would indicate that this development is a consequence of economic convergence. This points to a new generation of Irish MNEs investing abroad and supports the trend identified by Forfás (2001).

Barry et al (2003) question why there is so little outward Irish vertical FDI to lower-cost production locations. Recalling that firms invest abroad because they possess firm-specific assets (ownership and internalisation advantages), it is suggested that ‘R&D and superior product differentiation through advertising are generally found to be the most important firm-specific assets associated with multinationality’. (Caves, 1996; Markusen, 1995)… ‘Irish multinational companies do not appear therefore to follow the standard pattern associated with multinationality’. (Barry et al, 2003: 346) They propose that the predominant proprietary assets which Irish firms possess are in the fields of management and expertise, mainly in non-traded sectors.
Barry et al suggest that proprietary assets other than R&D and advertising appear to be associated with the horizontal multinationalisation of Irish firms. ‘The fact that the proprietary assets of Irish MNEs do not lie in these areas serves

as an illustration of the difficulties facing firms in late-developing regions in surmounting the entry barriers that characterise more conventionally multinational sectors'. (Barry et al, 2003: 346)

Ireland's development along the Investment Development Path and the nature of its outward FDI has implications for Irish investment in China. This research analyses the relevance of Barry's model that Irish outward FDI flows are disproportionately horizontal and oriented towards non-internationally traded sectors, for Irish FDI into China by undertaking research among all Irish companies (employing ten or more staff) which have invested in China. This permits an analysis of whether or not such FDI is disproportionately horizontal.

Furthermore, the composition of Irish FDI in China to date is examined to analyse whether it is to be found in the internationally-traded or non-traded sectors.

China and Inward FDI

Wei and Liu (2001) identify China's decision in 1979 to accept FDI as being the result of a fundamental shift in political leadership and economic policy. The new Chinese leadership recognised that attracting FDI was important for several reasons. It would introduce foreign capital without increasing China's external debt. It would introduce advanced technology, equipment and managerial expertise. It would help improve technology levels in existing industry and introduce export-oriented practices. It would increase China's social capital through training and skill transfer. Finally, it would create additional jobs, probably at higher wage levels.

There have been four distinct phases of development of FDI in China since 1979: the experimental period (1979-83); the gradual development period (1984-91); the peak period (1992-98); and the adjustment period (1998-present). In the experimental period (1979-1983) a limited amount of FDI was introduced into four special economic zones (SEZs) – Shenzhen, Zhuhai, Shantou and Xiamen. Foreign investors had no experience of investing in China since 1949 and were likely to be reluctant. However, these regions enjoyed strong links with Hong Kong and Taiwan. Accordingly, investors from Hong Kong and Taiwan were more likely to avail themselves of the opportunity to invest.

Over the past twenty-five years Chinese GDP and per capita GDP have grown at an annual rate of 9% and 8% respectively. In the last few years economies such as China and India have become the most favoured destinations for FDI as investor confidence in these countries has soared. According to the FDI Confidence Index (A. T. Kearney, 2005), China and India hold the first and second position respectively, whereas the United States has slipped to third position.

Until recently the dominant source of inward FDI in China has been Hong Kong, followed by Japan, the United States and Taiwan. Approximately 59% of FDI has gone to the manufacturing sector, much of which is in labour-intensive industries such as textiles and mechanical and electronic products. (Wei and Liu, 2001) With structural changes in the Chinese economy the composition of inward FDI has also altered. In 1989, 83.3% of FDI was in manufacturing sectors. By 1993 this figure had dropped to 45.9%, while the share of real estate and utilities had risen from 9.4% to 39.3% in the same period. (Du Pont, 2000) This sharp increase in real estate and utilities is of interest to commentators on Irish outward FDI given the level of outward Irish FDI in the construction sector. The movement away from manufacturing in favour of the service sector should be of benefit to Irish investors given the predominately non-traded nature of Irish outward FDI, as identified by Barry et al. This issue will be re-examined following the elucidation of the results of our research.

Li and Li (1999) explore the reasons why MNEs invest in China. They identify two categories of investors in China. Firstly investors from developed economies, such as EU countries, USA and Japan, who tend to invest in the larger cities such as Shanghai, Guangzhou, Tianjing, Dalian and Beijing. They tend to introduce new technology, new management styles, the scale of investment tends to be larger and the focus is on exploiting market opportunity.

The second category comprises mainly Asian investors (excluding Japan), such as Hong Kong, Macau, Singapore and South Korea. Investments from this category are mostly in labour-intensive industries with production geared towards exporting. The size of the investment tends to be smaller and few investments bring new technology to China. Li and Li (1999) argue that while cheap labour is an important determinant for MNEs in this category, companies in the first category are likely to be attracted by the large and growing consumer market and the significant potential for future development. This phenomenon will be explored in our research to examine whether or not Irish MNEs conform to this categorisation.

While FDI is still concentrated in the coastal region, the Chinese Government currently has a policy of ‘opening up the west’. This will see a strong push to open up central and western regions of the country with associated government incentives, and can be expected to be a dominant theme in the next phase of

China's FDI history. This policy has a bearing on inward investment decisions and will be explored later within the context of our consideration of the regional dimension of FDI in China.
While Chinese society has undergone profound changes in the past twentyfive years and has made unprecedented gains in economic growth, traditional values still exert a strong influence. The investment challenges which China holds will be explored fully in chapter three, but two areas, relationships and contract law, are of particular importance to the conduct of business in China. Accordingly, they will be considered at this stage in order to provide a foundation for our later discussion.

Relationships and Contract Law
At the inter-cultural level, networking can bridge the gap between business people of different nations and cultures, hence stimulating trade and investment (Luo, 1998). Networking at both a personal and corporate level in China has its roots in Chinese culture and Confucianism. A particular form of networking has developed over the centuries and is referred to as Guanxi. This refers to the concept of drawing on connections so as to secure favours within a structure of personal relations. It is an intricate and pervasive relational network which Chinese cultivate energetically, with a history of more than 2,000 years. (Luo, 1998) The difference between guanxi and western business networking is that the former also includes social as well as commercial contact. Chinese businesspeople believe that one should develop a relationship and, if this is successful, business will follow. In contrast, western business people believe that a relationship may develop following the conclusion of successful business transactions. (Ambler and Styles, 2000; Tsang, 1998) Both guanxi and western networking emphasise that relationships are not discrete events in time, but are of a continuing nature. A notable difference is that guanxi leads to a strengthening of social relations, which may or may not be called upon in the future.

Guanxi also exists at an organisational level. Inter-organisational guanxi (guanxi hu) builds upon personal relations. Commentators such as Xin and Pearce (1996) argue that, since the cradle-to-grave provision of social services by one's employer (referred to as the 'iron rice bowl') was broken in the early 1980s with the advent of foreign companies, the application of guanxi at the organisational level has become more pervasive and intensive. Any firm in Chinese society, be it local or foreign, inevitably faces guanxi dynamics. (Luo, 1998) Guanxi requires business people to develop relations not only with suppliers and customers, but also with key government officials. 'Such personal connections are imperative to managers in China given the absence of the stable legal and regulatory environment that would facilitate impersonal business activities. Institutional uncertainty during economic transformation has been quite high'. (Luo, 1998: 172)

Jones (1994) argues that business practice in China relies on guanxi rather than on law and legal institutions as the basis of security of expectations. She states that guanxi provides a crucial role in business activities, being the basis for trust. It is therefore a source of stability, certainty, predictability and risk-reduction. Guanxi can serve as a substitute for legal enforcement and fills the void left by the absence of a developed legal system. (Jones, 1994) Guanxi provides a 'substitute form of trust that can improve the profitability of investment and reduce the risk of arbitrary bureaucratic interference that is not in the interests of investors'. (Smart, 1993: 398)
Jones (1994) contends that a distinctive form of capitalism has developed in China and she asks how one can explain the success of an economy dominated by the 'rule of relationships' rather than the 'rule of law', as predicted by Weber's hypothesis.
According to Weber, the operation of market capitalism depends on the existence of incentive to engage in economic activities, and the security of expectation of economic benefit flowing from such activities is an essential element of such incentive. Such security can only be provided by the predictable application of state coercion through logically formal and rational law… [This] type of legal system constitutes a favourable, and almost essential, condition for market capitalism. (Chen, 1999: 99)

Jones states that, when the spectacular success of Hong Kong is repeated in Singapore, Taiwan, South Korea and now China (which she labels the 'fifth tiger'), the possible common denominator is their shared cultural emphasis on familial and business networks as opposed to legal institutions. (Chen, 1999) These are 'the very things Weber regarded as barriers to capitalism'. (Jones, 1994: 197) Weberians tend to distinguish between the universalistic West and the particularistic East, depicting the Western model as being favourable to capitalism and the particularistic East as inimical to it. Jones (1994) argues that in China particularism is in the ascendant (in the form of guanxi and familism),

defying theories that associate Western universalistic values with the growth of capitalism. '[D]espite its lack of formal legal rationality, mainland China also seems able to provide sufficient predictability, calculability and stability for capitalism to thrive. It can be argued that guanxi facilitates rather than hinders this process'. (Jones, 1994: 200)
Jones (1994) suggests that the rule of law is relatively absent from China and that guanxi is frequently preferred. She draws on Unger's differentiated notion of law to identify the legal and quasi-legal forms found in modern China, which may be either interactional, bureaucratic/regulatory or full legal order**[iv]**.

The final category is what one normally associates with the Western concept of the Rule of Law. Jones (1994: 204) argues that 'while law in China is primarily of the second sort (that is regulatory/bureaucratic), China is a legally pluralistic society in which guanxi plays a central role but "full legal order" is absent'.
Guanxi therefore enables business to be done with strangers in a context of mutual trust and certainty; those who break this trust show 'bad faith' and stand to lose an important form of social capital, that is their reputation or 'face'. In a society which places great importance on 'face' and trust, breaking faith may mean expulsion from guanxi-networks and exclusion from future business deals. (Jones, 1994: 205)

Contemporary China suggests that the existence of a rational legal system, in the Weberian sense, may not be a necessary or highly relevant condition for the development of a market economy. (Chen, 1999) Indeed, the Chinese authorities have stated clearly that, while the Western model of economic development was adopted, it was never intended to adopt the Western notion of the Rule of Law. (Deng Xiaoping speaking in 1988) The notion of the separation of powers was anathema to Deng Xiaoping, the architect of the opening-up policy – once a decision has been taken it could be implemented without 'one branch of government holding up another'. (Xiaoping, 1988, cited in Jones, 1994) 'Chinese law is an instrument of politics to be interpreted not by an autonomous judiciary but by the National People's Congress'. (Jones, 1994: 208)
This leads one to ask if normal business can be conducted where a pervasive network of relationships exists. In particular, do western investors face challenges given the lack of the legal certainty which they would be accustomed to in areas such as contract law? But is contract law an absolute reference point in the conduct of commercial activity in Western society? In his seminal study on non-

contractual relations in business, Macauley (1963) sets out a view of contract law**[v]** in the West which is open to interpretation, contestation and modification. His study outlines a scenario where relationships are central to business transactions, with little recourse to legal sanctions. 'Business exchanges in nonspeculative areas are usually adjusted without dispute'. (Macauley, 1963: 60) Business people try to solve conflicts themselves and in so doing they do not refer to the content of the contract. (Roxenhall and Ghauri, 2004) Indeed 'law suits for breach of contract appear to be rare'. (Macauley, 1963: 60)
Macauley (1963) asks why contracts and legal sanctions appear relatively unimportant in the business world. He identifies the understanding of an agreement by both sides as ensuring that the nature and quality of a seller's performance is understood. This understanding is facilitated by experienced professionals who are familiar with industry specifications and standards. In addition, there are alternatives to legal sanctions associated with the firm's standing in the industry, such as the honouring of one's commitments and the perception that the quality of one's product is to be trusted. 'At all levels of the two business units, personal relationships across the boundaries of the two organisations exert pressures for conformity to expectations'. (Macauley, 1963: 63) The ultimate non-legal sanction is the desire to maintain a successful business relationship.

Businesspeople often prefer to rely on informal agreements, such as a handshake, rather than to agree to a formal contract. Roxenahall and Ghauri (2004) argue that this occurs because parties want to continue to do business with each other in future. Macauley (1963: 64) contends that 'not only are contract and contract law not needed in many situations, their use may have, or may be thought to have, undesirable consequences. Detailed negotiated contracts can get in the way of creating good exchange relationships between business units'. Pointing to the negative dimensions of contracts, he argues that the existence of a contract may result in performance being satisfied only to the letter of the contract. Businesspeople at times want a degree of vagueness so that they can react to changed circumstances. In addition, resorting to litigation will inevitably mean an end to the business relationship. Nevertheless, Macauley (1963) envisages situations where the threat of legal sanctions will have more advantages than disadvantages. These include the internal needs of an organisation, where pressure is required on departments within the firm to ensure that standards are achieved, where complex performances are agreed over a long time period, and where default is thought to have potentially serious repercussions.

Overall, Macauley (1963) identifies a reluctance among businesspeople to engage in negotiating contracts. Even when they do and one party defaults, there is a marked reluctance to pursue legal avenues. This is because businesspeople see a relationship as more important than one particular transaction. Given the importance of establishing a strong network of relationships in China (guanxi) and the relative lack of importance of detailed contracts in the conduct of business among western business people, one would assume that investors in China should not be particularly interested in concluding formal and detailed contracts with Chinese partners. This issue will be explored in our research with the executives of firms which have invested in China, to discover if, given the strength of guanxi in China, trust and credibility play a more salient role than legal contracts. (Tsang, 1998)

Conclusion

This chapter provides an overview of the most pertinent literature on key issues which will guide our future discussion. The definition of investment which has been adopted centres on management control and this will inform the selection of firms for inclusion in our research. While there are several theories on investment, it is argued that Dunning's eclectic paradigm provides a comprehensive and dynamic approach. It builds on the work of earlier theorists such as Hymer. It sets out three preconditions which must exist for FDI to be successful – ownership-specific advantage; location-specific advantage; and internalisation advantage. FDI theories such as Dunning's have developed with the role of MNEs as central to our understanding of foreign direct investment.

As the largest recipient of inward FDI, China exerts a key influence in international economic decisions. FDI in China has made remarkable strides since the 'opening up' policy was introduced in 1979. In the space of one generation it has become a magnet for FDI. That said, the business environment holds challenges, particularly in the deep culture of relationships and the underdeveloped nature of the legal system.

Barry et al (2003) have developed a model of Irish outward FDI by analysing FDI outflows to developed economies, the traditional destination for such FDI. However, as a developing economy China exhibits particular traits and characteristics. Research among executives of MNEs which have invested in China will identify the locational advantages and disadvantages which China holds and enable us to draw conclusions as to whether Barry et al's model is applicable in the case of China.

NOTES

[i] This reputation is based on the hypothesis advanced in his doctoral thesis in 1960 (published in 1976 only). He moved through three phases during his short life: the first was based on his thesis; the second was a neoclassical phase, and the final was his Marxist period.

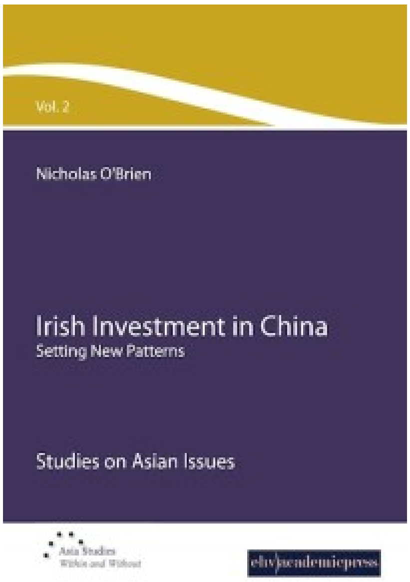
[ii] The general unavailability of statistical data on outward FDI flows is also highlighted by Buckley and Castro (1998), who cite this as a reason for researchers' apparent reluctance to test the IDP hypothesis.

[iii] US data is used as the US Department of Commerce makes data available on the nationality of inward FDI on a time-series basis.

[iv] 15 Unger's concept of 'law as legal order' is almost identical to Weber's rational law. (Chen, 1999: 99)

[v] Contract is defined by Macauley (1963: 56) as consisting of two stages: (i) rational planning of the transaction with careful provision for as many contingencies as can be foreseen and (ii) the existence or use of actual or potential legal sanctions to induce performance of the exchange or to compensate for non-performance.

Chapter 3: The Views of Investors ~ Irish Investment In China. Setting New Patterns



Introduction

As indicated above, traditional Irish outward FDI to the US and Europe is disproportionately horizontal in nature and is concentrated in the non-traded sector. (Barry et al, 2003) This chapter explores the views of business executives as to the rationale underlying their investment in China, their experience since investing, the disincentives and barriers to investing in China, and the role which executives see for state support in ameliorating the locational disadvantages which China poses.

By analysing the organisation and scope of activities of Irish MNEs which have invested in China, conclusions can be drawn as to whether Barry et al's model is applicable to Irish FDI into China. The experiences of executives in both the Irish and non-Irish MNEs categories allow us to draw conclusions as to the locational challenges which China may pose. These perceptions and an analysis of the investment climate in the next chapter will permit conclusions to be drawn as to whether the validity of our sub-hypothesis holds, namely that the Chinese investment climate is considerably different from that faced by Irish investors in developed economies, the traditional location for outward FDI.

Should significant locational disadvantages be found to exist, within the meaning of Dunning's eclectic paradigm, our prescriptive research question will examine the potential role which exists for government to assist potential investors.

This chapter sets out the results of the research undertaken for this study. Initially, the profiles of the investing companies (both Irish and non-Irish) will be set out, but in a manner which respects the confidentiality offered to interviewees. This will be followed by a consideration of the investment rationale and the available incentives, which drove the MNE to invest in China. Using this framework, the locational advantage which China offers can be identified.

Locational disadvantages will also be explored by examining the experience of executives since investing. The manner in which MNEs protect their ownership advantage through utilising internalisation advantage will offer guidance to potential Irish investors. Perceptions on the role of the state will be explored, which will assist in the consideration of our prescriptive research question. This will be followed by an evaluation of the views of Irish MNEs which have invested in Eastern Europe. It will be interesting to note if their perceptions as to the challenges facing investors in China will be borne out by the view of both Irish and non-Irish MNEs which have already invested in China.

Profile of the MNEs included in this Research – Irish MNEs

There is a significant variation in the size and scope of the Irish MNEs which have invested in China. The average size of the MNE's investment in China was € 168 million. However, this figure is skewed by one large investment greater than €1 billion. When this investment is excluded, the average investment of Irish MNEs was € 6.3 million, which represents a significant commitment on the part of the parent Irish firm. The average number of employees in the Chinese subsidiary of Irish MNEs was 332. Again, this is distorted by the size of one MNE. Excluding this MNE, the average was 49 employees. This is not a large number of employees by Chinese standards. Perhaps this small number can be accounted for by the fact that just under half of the subsidiaries are in the hi-tech sector, where employee productivity tends to be high, and another is in the property sector, but not directly engaged in construction projects. LOCOmonitor (2006) found that the average number of employees in the overseas subsidiaries of Irish MNEs is 147. Taking all Irish investments in China, the number of employees is higher than the global average.

Turning to the parent Irish MNE, globally Irish MNEs which have invested in China had an average annual turnover of € 1.4 billion. Again there are large divergences within this average figure. The average number of employees globally was 4,247. This data gives an indication of the size and diversity of the MNEs which were included in this research.

Having analysed the activities of the Chinese subsidiaries we can say that, of the Irish MNEs which have invested in China, just over 80% are in the traded sector. The proportion between vertical and horizontal FDI is broadly equal. These results have significant implications for this research and indicate that Barry et al's model is not directly applicable for the current wave of Irish investment in China, as it is largely in the traded sector and could not be described as disproportionately horizontal. We shall return to these findings in chapter five, when the nature of Irish FDI into China is explored.

Non-Irish MNEs

Among the non-Irish MNEs included in this study, the average investment was € 520 million, compared with the average Irish investment of € 168 million.

The average turnover of the Chinese subsidiary of the non-Irish MNE was € 210 million and the average number of employees in China was 4,047. Globally these MNEs had an average turnover of € 68.6 billion. The average number employed globally is 114,000. While the scale of these MNEs and their Chinese subsidiaries is larger than that of the Irish MNEs and their subsidiaries, the non-Irish MNEs were selected with reference to the Government's Asia Strategy. In addition, the interviewees selected were involved in the initial decision to invest in China and have considerable experience of the investment climate in China.

Analysing the activities of these subsidiaries, it can be said that all of the investments were horizontal in nature and that 75% operate in the traded sector. While the breakdown in the traded/non-traded sector is not very different from that of the Irish MNEs, the FDI of the non-Irish MNE population is totally horizontal. This finding should not be given undue weight as it would be possible to assemble a cohort of MNEs which replicates the Irish MNEs. Based on this research, and accepting the limited size of the population, there would appear to be a stronger level of FDI in the traded sector. This is possibly a reflection of the dominance of manufacturing in the Chinese industrial base. However, this is changing along the eastern seaboard with the service sector increasing in market share. We shall return to this topic later.

An interesting comparison of the ratio of turnover and staffing of the Chinese subsidiary as compared with the global operation shows a divergence between the Irish and non-Irish MNEs. Of the Irish MNEs, the average turnover of the Chinese subsidiary as a percentage of global turnover was 46%. The average employment was 40%. However, in the case of the non-Irish MNEs the turnover of the Chinese subsidiary as a percentage of global turnover was 14%. The corresponding data for employment was 4%. Presumably this is a reflection of the truly international nature of the non-Irish MNEs and conversely, the limited international operations of Irish MNEs, with the Chinese subsidiary playing a significant role in the corporate structure of the Irish MNEs. It also points to the increasing number of medium-sized Irish companies which are investing overseas. This supports the view of Moosa (2002) who, in discussing the strong rebound which took place in international FDI after the slowdown in 1990-92 associated with the East Asian financial crisis, points to the growing role of smaller firms engaging in outward FDI.

Structure of the Chinese Subsidiaries – Irish MNEs

Among the Irish MNEs, just under 20% are in joint venture arrangements and just over 80% are Wholly Foreign Owned Enterprises (WFOEs). The joint venture MNEs decided to enter into this form of arrangement as it was perceived as the easiest manner in which to enter the particular markets in which they are active. In one case the MNE established a relationship with a Chinese partner firm which is in a position to obtain the required licence. (At the time of entry only domestic firms could be licensed. While this restriction has now been lifted, de facto it still proves difficult to obtain such a license.)

Most executives were opposed to the concept of a joint venture structure. They cited the risk of the loss of intellectual property rights (IPR) as a reason for not entering into a joint venture, fearing that their technology would be leaked to competitors. One executive commented that he 'would not be happy to go in with any third party given the hi-tech risk we would face'. The consulting company executive observed that virtually all new investments in China are Wholly Foreign Owned Enterprises with a marked reluctance to enter into Joint Venture arrangements. He sees the lack of accountability within a Joint Venture, particularly on the Chinese side, as one of the main weaknesses of this form of market entry. In addition, he described a Joint Venture as a particularly bad way of protecting intellectual property.

Among the Irish investments all but one were greenfield investments. However, most Irish outward FDI uses M&A activity as an entry strategy (O'Toole, 2007). When this issue was raised during interviews, one executive replied that 'the challenges associated with due diligence is not something we wanted to do'. 'Even in Ireland, before entering into a joint venture you would conduct a lot of research and due diligence investigation on a prospective partner, and in China that's even more important'. (Enterprise Ireland, 2005: 17) Cantwell and Santangelo (2002) argue that merger and acquisition activity is at a considerably lower level in Asia than in other regions. The gain in market power is greater if an investment takes the form of a merger or acquisition as it directly eliminates one potential rival. The threat which a joint venture arrangement poses to the protection of intellectual property rights can be considered as a locational disadvantage which threatens the MNE's ownership advantage. Lieberthal and Lieberthal (2004) argue that joint ventures are particularly difficult in China because of diverging objectives between the two partners. While most MNEs want to reinvest profits to increase market penetration, Chinese firms, which are typically cash-strapped, want to extract profits.

Non-Irish MNEs

Almost 90% of the non-Irish MNEs are Wholly Foreign Owned Enterprises (WFOE). One of the executives recalled the experience of joint venture arrangements which the MNE had previously had:

In terms of ownership structure, we started life in China as a joint venture. At one stage we had over ten joint ventures and only two years ago did we manage to bring all their operations into a single WFOE. In a JV (Joint Venture) too much energy is spent meeting the needs of the JV partner rather than concentrating on core business objectives.

A financial services executive pointed out that foreign banks are reluctant to purchase 20% or more of any Chinese financial institution. If the bank does so, the Chinese subsidiary would be subject to prudential supervision by the financial regulator in the bank's home economy.

One of the non-Irish MNEs operates in the education sector. While it does not have a joint venture arrangement, it has a Chinese partner with a minority shareholding. This is not unusual in this sector, as education is tightly regulated by the authorities. We shall return to this issue in chapter five, as education is one of the sectors identified in the Government's Asia Strategy as offering the potential for deepening economic ties with Asia.

A view among the executives interviewed is that control is important when making an investment in China. This supports the view of Moosa (2002), who states that control is a distinguishing feature of FDI as compared with other forms of investment. It can be deduced from the response of interviewees that a joint venture company structure is a locational disadvantage within the meaning of Dunning's eclectic paradigm. A wholly foreign-owned enterprise (WFOE) represents an internalisation advantage. There is the additional risk that a joint venture arrangement may lead to a leakage of intellectual property. Should this occur, the MNE's ownership advantage would be dissipated. Accordingly, when investors are considering the appropriate organisational structure to adopt for their Chinese subsidiaries, they should seek to retain internalisation advantage by utilising a WFOE structure and thereby avoid threats to ownership advantage.

Rationale for Investing and Incentives

An examination of why MNEs invest in China is of assistance in identifying the locational advantage which China offers.

Irish MNEs

Of the Irish MNEs, over 80% decided to invest in China because of the market potential which is on offer, 10% invested because of the locational advantage which China offers in labour costs, and just under 10% invested for both market opportunity and labour cost considerations, with a slight preference for the latter. It can be said that within Chen and Ku's (2000) categorisation, the vast majority invested for expansionary purposes.
The principal benefit identified by virtually all investors is the market opportunity which China presents. These MNEs see the emerging market in China as the natural progression to their existing activities. They recognise the emergence of the middle class in China, which has increasing amounts of disposable income to spend on consumer products. In addition, they see investing in China as adding value to their global operations. O'Toole (2007: 394) argues that 'most of the FDI from Ireland is motivated by gaining access to overseas markets'. This research corroborates this view and shows that Irish FDI into China conforms to this general pattern.

In some cases MNEs are following companies with which they already have a close business relationship and who have already invested in China. One executive stated: 'Some of the large US multinational companies which we supply were moving their operations to China. This factor made the decision to invest easier as there was a need to follow our market'. This view is corroborated by a non-Irish MNE executive who pointed out that all of their suppliers have established a production facility in China in order to maintain their supply contracts. An interesting observation made by an Irish MNE executive in the hi-tech sector was: 'Not all our international competitors were operating in China. Therefore, we knew we would not face the same level of competition as we do in the USA. In addition, there were no Chinese competitors in the specialised hi-tech area in which our firm specialises'. Another executive argued that in the electronics industry 'you have to be in China, simply because all the suppliers are here. Time-to-market is crucial to gaining contracts. Because all the components are made here, we had no choice. Nowhere else has the capacity'. An executive of a chemical MNE commented that 'the attraction of China is its very large market. While the technology they use is very different to ours, Chinese producers can produce at lower cost. We can't afford to be outside the market. To sell within, we will use our production facility as a bridgehead'.

A packaging executive spoke of a new market emerging for foreign investors within China – ‘Chinese companies want to sell products in Europe and the States; to do that, they need European standards. That’s where we come in’. Food sector MNEs have decided to focus on the business-to-business sector rather than attempt to penetrate the retail sector which is viewed as:

…too complex for foreign companies to break into. Maybe we will look at it in ten years time. A strategic decision has been taken to focus on the business-tobusiness market rather than the retail sector. The retail sector is really complex for foreign companies, given the distance from the home economy and the branding challenges which would require a significant outlay on advertising.

Worthy of note is the additional opportunity which one MNE has identified. It intends servicing its market on the west coast of the USA from China rather than from Europe, which it currently does, as the costs involved are considerably lower.

There was a clear perception that the immediate market potential is along China’s eastern seaboard. Establishing an operation in the centre or west of the country was described by one executive as ‘challenging, mainly because of the undeveloped logistics system.’

One MNE invested with a dual objective. Firstly, it wished to exploit the market opportunity for its existing products. Secondly, it wanted to use its plant in China to manufacture components for its global supply chain as a means of reducing costs.

Only in the case of one Irish MNE is the relatively low cost of labour the prime motivator. Buckley (1989) argues that location advantage enables MNEs to gain maximum advantage from differential prices of non-tradables in particular locations, particularly labour costs.

The dominant objective of exploiting market opportunity among Irish MNEs is in contrast to the perception that investors are attracted to China because of cheap labour. This finding supports the views of Li and Li (1999), who argue that investors from developed economies are likely to be attracted by market opportunity rather than low-cost labour. These findings are also in line with Van Den Bulcke et al’s (2003: 58) analysis of EU investment in China, which is that ‘they [EU investments] are relatively more concentrated in capital and technology intensive sectors, have a large investment size and a high localmarket orientation’.

Non-Irish MNEs

All of the non-Irish MNEs included in this research invested in China in order to exploit market opportunity. However, two identified low labour costs as a factor contributing to this decision, but stressed that market opportunity was the primary motivation. The consumer products executive stated that ‘we decided to invest simply because of the size of the potential consumer market – 1.3 billion consumers’. Another executive expanded on the market opportunity which the MNE had identified: ‘China is a natural extension of our geographic business; there was a need to “follow our customers” as we are heavily involved in funding the exploitation and acquisition of natural resources’. The executive of another MNE mentioned that most of the firm’s suppliers have now located a manufacturing facility in China, which provides easier access to materials. This point is of interest to potential Irish investors who provide services and goods to other multinationals.
One MNE executive pointed out how important market opportunity is by indicating that labour costs played no role in the firm’s decision: ’We decided to invest in China solely because of the potential market. The cost structure of our firm is not typical; materials account for 50-60% of total cost and labour costs are typically in the region of 10%, so cheap labour didn’t bring us here’.
Reflecting the dual objectives of another MNE, the respondent stated: ‘We invested because we saw the market coming. But also to have a lower cost production base, not only for China, but also in south-east Asia. We can produce heaper in south-east Asia, but we can get good quality production cheaper in China than in Europe’.

The evidence presented above by the majority of interviewees, in the case of both Irish and non-Irish MNEs, points clearly to the locational advantage of the market opportunity which China offers. Building on the ownership and internalisation advantages which these MNEs possess, investors recognise the market opportunities which China offers, and wish to exploit it. Interviewees acknowledged that this market opportunity currently exists only along the eastern seaboard. This represents an important regional variation and modifies the locational advantage which China offers. Accordingly, it can be said that the locational advantage currently exists only in one segment of the Chinese market and not throughout the country.

Incentives

The level of incentives offered by the Chinese authorities did not feature prominently as a motivation for investing, among either Irish or non-Irish MNEs. As the majority of those interviewed cited market opportunity as their motivation for investing, this is not surprising. This view supports a finding in Agarwal's (1980) study, which shows that incentives have a limited effect on the level of FDI, as investors base their decision on risk and return considerations.

MNEs in the hi-tech sector spoke of attractive packages which are offered by local government authorities. One executive stated: 'As we are in the hi-tech sector, we were in discussions with the authorities in several locations to negotiate the best possible package'. The interviewee from the consultancy firm suggested that during the set-up stage, local authorities have considerable latitude when negotiating, with large investors who obviously possess the leverage to obtain a more favourable deal. He recommended that companies should establish their operations in a Special Economic Zone in order to gain the most advantageous tax and incentive packages.

Interviewees spoke of the various incentives available from local governments. One executive recalled how the MNE received considerable grant assistance when constructing its headquarters building. As it is a prestigious MNE, local governments competed strongly to attract the FDI to their particular regions. As a result of the generous land-use rights offered, the MNE effectively built its corporate headquarters at little or no cost. This points to a regional variation which investors should take into consideration when making an investment decision. As such, it can represent a locational advantage or disadvantage. We shall explore this further below.

The clear view of interviewees is that taxation played a role only in the choice of location within China and not in the decision to invest itself. One executive stated: 'while the tax arrangements are good, this is not why we invested. They help the bottom line, but even without them we would be here. The moves to increase corporation tax for foreign entities will not force us to change our strategy'.**[i]**

As discussed above, the literature on the effect of taxation on FDI offers diverging opinions. The result of this research confirms the view held by Moosa (2002) that it is the overall environment of a particular country which attracts inward FDI and the expected return on capital invested. In the case of MNEs which invest in China for market opportunity purposes, we can say that the relationship between taxation policies and FDI is not particularly strong for this category of investors.

While the following sections will explore locational disadvantages, it should be borne in mind that China continues to offer strong and very positive locational

advantages.
This almost goes without saying, given the strong levels of inward FDI which China continues to enjoy. The purpose of exploring locational disadvantages is firstly to assess their impact and secondly to explore whether or not it is appropriate for state intervention to ameliorate such locational disadvantages.

The first section, entitled 'Experience Since Investing' will explore the responses of executives to the questions relating to experience of the set-up stage, regulatory issues and transfer of technology. The responses identified in these areas can be considered to be minor locational disadvantages and offer an indication of the business environment facing investors. These challenges are not unique to China and could be experienced in other investment locations, in both developed and developing economies. As such, they can be considered to be in the realm of general locational disadvantages which investors face when establishing a subsidiary abroad. As set out above, the reality is that foreign companies will incur some additional costs in comparison with indigenous companies. These extra costs range from a culturally unfamiliar environment to legal and political uncertainties.
In the section entitled 'Disincentives and Barriers to investing in China', particular disadvantages and barriers to investment will be discussed.

Experience Since Investing – Irish MNEs
Executives of Irish MNEs spoke of the importance and challenge of obtaining appropriate business licenses. The executive of one hi-tech MNE commented that 'Not only do we need a business licence, we need a licence for each product we manufacture and an import licence as well'. This points to a complex regulatory regime. It also indicates the unfamiliarity of Irish MNEs with the requirement of obtaining business licences, which is not a practice in Ireland.
Some specific issues were highlighted. The service sector MNE pointed to the difficulty of operating in a restricted sector. While this sector has recently been opened up to international investors, in line with China's WTO commitments, the executive is reluctant to apply for a licence, as the one foreign firm which has done so has experienced enhanced regulatory surveillance in the conduct of its business.
One executive offered an example of the level of bureaucracy which Irish MNEs would not be accustomed to – 'If there is a discrepancy between the amount of raw materials bought by the company versus the amount of goods estimated to be

made from that amount, the customs will halt the shipment until the discrepancy is cleared up'. While the purpose of this approach is to prevent the loss of fiscal revenue, it presents a challenge which MNEs operating in the West would be unaccustomed to.
One of the food sector executives complained of a lack of national treatment:
'Food ingredient importation is particularly restrictive with Chinese companies not subject to the same level of rigour and inspection. This is a form of non-tariff barrier and one which merits government intervention'.

A consistent challenge identified by executives is the difficulty of locating and recruiting suitably qualified staff. 'One of the main obstacles experienced by our firm is the ability to attract management who are competent and can integrate into the firm's culture'. Lack of managerial expertise was also identified as an on-going difficulty. This view is corroborated by the OECD (2000).
Another executive was of the opinion that the *'biggest difficulty during our set-up phase was identifying and employing a suitable country manager. We only located someone through the help of Enterprise Ireland'. An executive in a firm for which delivery times are critical stated that the firm 'couldn't afford to lose staff, so at an early stage I decided to pay 15% above the going rate'*.

Non-Irish MNEs
Executives of non-Irish MNEs were less pre-occupied with the business licence issue than were Irish investors. Most executives were of the opinion that if the paperwork was in order, the licences could be obtained in a relatively straight-forward manner. One executive stated that when he worked in Germany, licences could take longer to obtain. This difference between the perceptions of Irish and non-Irish investors may be accounted for by the fact that industry may be more regulated in continental Europe than in Ireland, with permits and licences required to a greater degree.

In the banking sector, inhibiting factors which are currently restricting the development of banks were identified in initial interviews. An executive complained of the obligation to deposit RMB500 million (approximately euro 50 million) for capital adequacy purposes for each branch that is opened. This condition does not apply to Chinese banks and, as such, can be seen as a non-tariff barrier. He stated that he is keenly awaiting 1 December 2006, when China is obliged under its WTO commitments to grant national treatment to foreign banks. The banking executive was re-interviewed in 2007. Since then, China had made provision for foreign banks to incorporate in China. (In April 2007 four foreign banks were granted national incorporation by the Chinese regulatory authorities). By incorporating they will move closer to obtaining national treatment and the capital adequacy requirement per branch will be removed. He was of the view that, while not yet perfect, China has made significant strides in opening up its banking sector.

A telecoms executive referred to the high level of state control in the telecommunications industry. The fixed line and mobile network is state-owned and there is scope for investors in the telecoms equipment sector only. An education company executive pointed out that this sector is highly regulated for political reasons. Foreign investors at the third level must have a Chinese institutional partner. 'There is scope for investors in the international schools sector, which is booming. But even there you need the local government as a partner if you want to have a trouble-free existence'. These issues are of relevance to this research as the Government's Asia Strategy highlighted these sectors as promising a deeper engagement with China. It is important that these locational challenges should be appreciated by potential investors.

Technology transfer is an important consideration for the Chinese authorities. One executive recounted his experience of the investment negotiations:
'The Chinese side insisted that we use the latest available technology. This resulted in an USD900million investment. If we had been allowed use lower specification technology, which would have produced much the same output, our investment costs would have been halved'. He suggested that the transfer of technology is very important to the Chinese side in granting approval for investments. This poses a dilemma for potential investors given some of the views expressed on the lack of protection for intellectual property rights. Investors will need to take steps to adequately protect key technology to avoid the proliferation of one's technology into what one executive described as *'communal property'*.
The issue of recruiting and retaining qualified staff featured as a challenge, in the experience of executives of Irish MNEs. One executive stated that his firm currently employs 1,000 staff and expects this number to grow to 5,000 in five year's time, although he added 'if we can find suitable people'. Another who had experienced difficulty with recruiting and retaining qualified experienced staff suggested that the most likely staff member to leave is the number two in each department, as s/he sees little opportunity for advancement. This opinion is

corroborated by the view of another executive, who stated that staff retention has not been a major problem as there have been plenty of promotion opportunities. He argued that the availability of opportunities for advancement is more important than pay in relation to staff retention.

Borensztein et al's (1995) model of endogenous growth, which uses technological progress as the main determinant of long-term economic growth, argues that more advanced technology requires the presence and development of a sufficient level of human capital in the host economy. If this condition is not satisfied, then the absorptive capacity of the developing host economy will be limited. This complementarity between FDI and human capital is evident in the response of virtually all interviewees, where they raise the challenge of recruiting and retaining suitable staff. This limitation may restrict the level of inward FDI in certain industries in future years. It remains to be seen if this limitation is of such magnitude that it could offset the locational advantages which China offers. What can be said at this point is that the executives are keenly aware of human resource limitations. One executive pointed out that these limitations may restrict their expansion plans. To date, however, they have not inhibited FDI growth.

The general experience of investors in the set-up and early stages could be described as time-consuming, bureaucratic, but not particularly challenging. The environment could be seen as no more challenging than investing in any other developing economy. Issues highlighted tended to be of a sectoral specific nature. At this point, drawing on the results of this research, disincentives and barriers to investment will be explored with a view to identifying the particular locational disadvantages which China poses for investors.

Disincentives to Investing in China

The major disincentives and barriers identified were described in response to the questions relating to cultural challenges and perceptions on the role of contract law. The main challenges can be broken down into three distinct areas, viz guanxi, intellectual property rights, and contract law.

Guanxi – Irish MNEs

Executives of Irish MNEs spoke of the importance of networking in the conduct of business affairs. In addition, the need to build relationships with relevant officials was also identified. Executives saw the need to interact and develop stronger relationships with officials as time-consuming and a 'cost' which one would not

have to incur in Ireland. One executive spoke of initially being quite nervous in dealing with the local authorities at a more intense level than in Ireland – ‘It took quite a while to come to terms with officialdom; they wanted us and were very accommodating. But agreements can be altered by government officials, so we know that we need to have a strong relationship with them’. This statement hints at the historical divergence between China and the West in terms of the power of local officials, as identified by Jones (1994). As set out in chapter two, laws were traditionally open to interpretation and local officials exerted considerable power. While this has changed in recent times, local officials still exert influence, given the role which the state plays in the economy. Therefore, Irish executives see the need to cultivate strong relations with officials as an important component of China’s business culture. This indicates a cultural difference between China and Western economies. As it represents a drain on the resources of investing MNEs, it is a locational disadvantage.
In addition, regional divergences were identified regarding the pervasiveness of guanxi. By and large, executives in the eastern seaboard region recognise the importance of developing strong relationships with business and official contacts, but did not stress the importance of guanxi as traditionally understood. They tended to see relationships in this region as slightly above the normal scope of business. One executive observed: *‘Guanxi is important outside the main economic centres. However, in cities such as Shanghai, doing business is somewhat similar to many other developed economies. Relationship building is important, the same as in any country, except you need to work with officials more’.*

The consultancy company executive suggested that:
Since the opening-up policy was introduced, a change in business culture has occurred. Guanxi was important 15 years ago, but is no longer as strong an influence in the major industrial cities on the east coast. This is not to say that business relationships and contacts are any less important than in any other economy. Doing business in eastern China is normalising, but the Government still has a large measure of control over the economy.

The executive of the service MNE stated that ‘Guanxi is very important in southern China, because the government controls industry’. Therefore, if Irish MNEs invest outside the eastern seaboard they are likely to encounter a higher level of locational disadvantage.

Non-Irish MNEs

Executives of non-Irish MNEs also spoke of the need to develop strong relationships with officials because of the level of bureaucracy which one has to contend with. One executive commented that 'Access is an issue, so I have to devote time to working the local officials. This means that I can solve problems quicker'. Another executive spoke of the regional variation identified by Irish MNEs. This MNE has re-located its manufacturing facilities from Shanghai to a province in the centre of the country. He stated that 'In terms of guanxi, we seek to build a strong relationship with the local mayor or party secretary, preferably the latter. We use this channel to negotiate difficult issues which we can't resolve at official level'.**[ii]**

This view corroborates the observations of Irish executives that there are regional variations in the practice of guanxi in China. Along the eastern seaboard, executives spoke of investing time in developing relations with key officials. However, away from this region, executives spoke of traditional guanxi and the need to develop strong relationships with officials. China would appear to have developed an intricate and pervasive network which investors must take cognisance of. (Luo, 1998)

An interesting observation on Chinese culture was made by the banking executive. He suggested that a positive dimension of Chinese culture which assists banks is the emphasis on guanxi. In his view, banks should be relationship and not transaction driven. Accordingly, he sees a synergy between Chinese and foreign banking cultures. This is of relevance to potential Irish investors as financial services are one of the eight sectors highlighted for deeper engagement with Asia in the Government's Asia Strategy.

Intellectual Property Rights – Irish MNEs

The lack of respect for intellectual property rights was raised by over half the Irish MNEs as an issue of concern. An executive of a chemical MNE recounted that the technology which they introduced into China has now proliferated throughout their Chinese competitors. 'Technology is seen as fair game, it is seen as communal property'. The executive of this particular MNE is firmly opposed to introducing its newest technology into China.

The protection of intellectual property was also identified as a key consideration for the food sector. One of these firms is currently planning how to best protect its intellectual property and is looking at importing a key ingredient from abroad to mix with the ingredients manufactured in China. This reflects the view of

Lieberthal and Lieberthal (2004) who suggest that critical technologies should be kept outside the Chinese manufacturing process as a means of compartmentalising production and thereby reducing the risk of IPR theft. Another executive pointed out that obtaining trademarks 'takes longer in China, takes at least 12 months to be reviewed, searched and granted, so this leaves plenty of time for the copying of products'. The executive of an MNE which has a joint venture arrangement spoke of the importance which the parent firm places on protection of intellectual property. 'We had to pick our partner very carefully and make sure that there is an incentive for them not to leak the intellectual property'.

IPR was not a concern for the Irish MNE which operates in a specialised textiles sector, presumably because the firm is operating in a niche market. One of the IT executives suggested that IPR is seen as posing the same challenges in China as it does in other overseas investments. He stated that he had a clear impression that the Chinese authorities wanted to be seen to be respecting intellectual property rights.

Non-Irish MNEs

The protection of intellectual property rights was also identified as a key concern by over half of the non-Irish MNEs. Counterfeiting was identified as a serious problem for the consumer products MNE. While the products are not of particularly high value, it is nevertheless profitable for counterfeiters to sell low-value substitute produce under the firm's brand name. Generally, the firm resorts to legal procedures only if the local administration cannot resolve the issue. However, the legal avenue has not always proved successful in the past, particularly if the violation occurred in a province outside the MNE's manufacturing base. This view was corroborated by a healthcare executive who referred to the challenge of avoiding counterfeiting, 'which we put a lot of resources into'.

Overall a picture was painted of a less than complete lack of respect for intellectual property rights. Both the European Union Chamber of Commerce in China (2005) and the American Chamber of Commerce Shanghai (2005) highlight the lack of enforcement of China's intellectual property rights laws. The European Union Chamber (2005: 71) expresses its concern that the enforcement on a national level of the IPR laws in China seems to be performed on the basis of specific high profile campaigns rather than on a permanent basis and is not evenly spread across all regions in China… it is a well known fact that counterfeit products are still found in significant quantities, in open or closed retail markets and that authorities being aware of this fact do not show any initiative to stop such sales.

The most visible expression of such counterfeiting is luxury items available in the markets. The EU Commissioner for Customs and Taxation**[iii]** expressed concern that the areas with the highest potential for counterfeit and which have substantial health considerations are pharmaceuticals, car parts and aircraft spare parts.

The literature suggests that FDI is a better route to protect one's intellectual property than licensing production to a third party. (Baranson, 1970; McManus, 1972; and Baumann, 1975) Internalisation also avoids the difficulty of what Buckley (1987) terms the 'buyer uncertainty problem' whereby the licensee obtains a transfer of intellectual property, as discussed above.

These considerations are particularly pertinent in the case of China. The threat to a MNE's intellectual property in China may represent a significant locational disadvantage. (This issue was also cited as a reason not to enter into a joint venture structure.)

Intellectual property is an ownership advantage. Therefore, FDI in China can also pose a threat to an MNE's ownership advantage. This research indicates that if an MNE is investing in China it should exploit its internalisation advantage and retain the production function internally. In addition, it must be constantly vigilant of the need to protect the MNE's intellectual property. This is particularly pertinent where hi-technology industries are involved as, should the MNE's intellectual property be lost, the MNE is effectively left with little ownership advantage.

Contract Law – Irish MNEs

Almost two-thirds of executives identified significant difficulties with the implementation of contract law in China. A view emerged of MNEs trying to cover all eventualities in a contract in the knowledge that, should difficulties emerge, there was little legal redress available. An executive stated:

'We try to cover everything in the contract but it is a very immature system and very difficult to enforce any breach. It cannot be relied upon, so managing any business relationship smoothly becomes much more important in order to avoid having to try to enforce a contract through court'. Another executive suggested that the 'quality of contracts in China is very good, probably better than Europe – because we put everything into it. It is written and signed, but how much value is that at the end of the day?' It was suggested by another executive that 'courts do not have a sophisticated approach to contracts because this is a trust based society'.

One executive, who had previously had a bad experience with the non-honouring of a contract by a Chinese firm, saw no merit in contracts because 'They will find ways to walk away… There are no safety nets like you would use in the West. There is no tradition… The courts don't have the stature to move things along'. In his previous dispute, the firm could not find a competent court which would accept jurisdiction for the case. This occurred ten years ago but gives an indication even today of the lack of a tradition of Rule of Law. An executive with a large manufacturing facility stated that he has 'no contract with any supplier. The day I put pen to paper, I don't trust them'. Such an opinion supports the view of Jones (1994), who suggests that the Rule of Relationships is more important than the Rule of Law in China. Overall, a view emerged of executives seeking to negotiate detailed contracts in an effort to cover as many eventualities as possible. However, there was also a recognition that in the event of a dispute, pursuing a legal route was not likely to be the most productive means of addressing it.

Non-Irish MNEs

The views of the previous category are mirrored by executives of non-Irish MNEs. One executive spoke of the detailed negotiations which the MNE's inhouse lawyer engages in when negotiating contracts. The contracts which the MNE uses in China are much more detailed than in their home economy. They clearly define conditions of delivery, service, etc, which would not require definition in the West. An executive of a pharmaceutical MNE recounted the level of detail which the MNE inserts into contracts but the value of contracts is relatively low compared to Germany or the US. Going to court is worthless. We have had clear cases but the other side declared bankruptcy, opened up another company and the court facilitated it. Contracts are only one small part of an overall relationship. [It's] just an addendum which reminds people of their rights.

Views of Lawyers

In order to explore further the role of contract law and the general legal framework, interviews were conducted with two lawyers on the specific issues of the legal environment and the role of contracts in the conduct of business in China. The first lawyer is a partner in the largest indigenous Chinese law firm and

works exclusively with foreign investing MNEs. The second lawyer is a partner in a large international consultancy firm and specialises in M&A activity by foreign investors.
The first lawyer suggested that one could consider contract law in China as being akin to a test of strength: 'If one side is in a position of strength, they will seek to include ridiculous conditions in contracts'. He suggests that this occurs when executives do not have a deep and trusting relationship. The second lawyer described contracts involving foreign MNEs as containing 'much too much detail. Between two Chinese companies it is very simple. He sees the reason for this as the under-developed nature of law in China. 'In Europe, there is a developed contract law – the law can interpret intentions. But China is a highly regulated society so lawyers advise that agreements must be specific. Therefore, lots of detail'. Later he added that 'contracts are linked to relationships. Before, the government owned the whole economy, so one's word was enough. Now, with so much inward investment, things have changed considerably.'

Should a decision be taken to commence court proceedings, the first lawyer suggested that it is much easier to take a case against a publicly listed firm in the province in which the MNE is located than against a private firm in another province. Again, a regional disparity in governance is evident. However, he cautions that litigation is not a happy event. While obtaining a judgement may not be a problem, enforcing it is not easy. Enforcement is just too difficult. Foreigners think they are the only ones who can't get judgements enforced, but it happens to everyone.
If an MNE is proposing using M&A as an entry vehicle, the second lawyer cautions that normally a deal is worked out based on financial information.

Due diligence normally indicates little divergence. Here, I believe that figures have traditionally not been used to measure performance. In a communist atmosphere, figures don't matter – just meet production quotas and pay tax. There is no profit motivation. Financial statements are completely different to the West. With the emergence of a private sector, accounts are still wrong. Tax is high, so the accounts are wrong. I suppose the financial statement is not complete, rather than not correct.

Regarding the general conduct of commercial law, the first lawyer identified a trend among foreign investors of seeking to insert a clause that made legal agreements and contracts subject to the legal jurisdiction of the home country.

'...[B]ut if there is no mutual co-operation agreement, which a lot of countries don't have with China, then such clauses don't make sense. It is completely up to the courts in China whether to implement a foreign judgement'. The second lawyer pointed out that much M&A activity is made subject to Hong Kong law. However, he cautioned that unless the Chinese partner has assets in Hong Kong, the merit of this approach is questionable.

Pointing to a general absence of the Rule of Law in favour of the Rule of Relationships, the first lawyer suggested that should a significant issue arise, the easiest and most effective method of dealing with it is to approach the provincial government. The local or county government will support the Chinese firm, but governments at provincial level want to attract more inward FDI so they are likely to support the foreign MNE 'or at least be neutral'. He recalled several cases which were settled in a satisfactory manner through this channel. However, he would propose this route only when there are significant issue to be resolved and not in the case of a problem with a sales contract.

A regional variation in the administration of law was identified by the second lawyer. 'Judgements in the east of the country tend to be fair, particularly in Shanghai and Beijing. In other areas, there is a tendency to protect local companies. The application of the concept of separation of powers is questionable'. He expressed the opinion that this has occurred because the focus of the authorities has been on economic development. *'Developing a legal environment doesn't have the same priority. The legal system wasn't well developed under the Communist system. What people say is that it takes too long to get to court. The government doesn't see developing capacity as a problem to be addressed'*. He also identified the lack of the award of damages as an issue which sometimes surprises foreign MNEs when they are considering litigation. '*Opportunity cost is not compensated. You have to prove how much you lost'.*

A picture was presented of contract law having little real impact on the conduct of business. Paradoxically, lawyers seek to cover a greater level of contingencies than in the West when negotiating contracts, but there is a recognition by executives that turning to the courts to impose the conditions which a contract contains is likely to be a costly and often fruitless exercise. Allied to this is the emphasis which executives place on the importance of building and sustaining good relationships. This corroborates the view that the Rule of Relationships supersedes the Rule of Law in China (Jones, 1994). We shall discuss this further in the following chapter.

Role of the State

All Irish and non-Irish executives, except one, saw no role for the home country government in providing financial support to investing MNEs. They were of the clear view that it was inappropriate for home governments to subsidise investment overseas and that investment should be undertaken based on clear economic rationale only. Only one executive had received support from his home government. He recounted his difficulty in obtaining start-up capital: *'It took us over a year to raise the capital for the initial investment. The catalyst for obtaining the funds was when Enterprise Ireland agreed to invest'.* When this point was raised with the Enterprise Ireland executive, it was pointed out that the agency made this investment on the basis that the head office and core functions would be located in Ireland. This can be seen as recognition of the importance and added-value which head office operations add to the Irish economy. We will return to this issue in chapter five.

All executives envisaged a role for home government 'soft' supports to varying degrees. There was a distinction between large and small MNEs, rather than Irish and non-Irish MNEs. The largest MNEs saw a role for state support in lobbying the Chinese authorities on issues such as national treatment (this was a particular issue in interviews with those from the banking and food sectors) and protection for intellectual property rights. The importance of double taxation treaties as a facilitator for investment was also recognised. The smaller MNEs agreed on the need for lobbying and bilateral taxation agreements but also envisaged a role for additional soft supports. The executive of one Irish MNE recounted how he decided to invest in China following the firm's participation in a government-led trade mission to China, when he visited the firm's Chinese customers for the first time. Based on these discussions, he identified China as a potential major market.

The role played by diplomatic missions and state agencies was recognised by respondents in this category. Because of the continuing high level of state involvement in the economy, executives expressed their appreciation of the role which diplomatic missions and state agencies play in terms of making introductions, their presence at events etc. One executive recounted the assistance offered by the home country's trade and investment agency in resolving an issue with the Chinese authorities. He pointed to the opaque nature of government in China and stated that once his own government became involved, the Chinese side responded.

Several executives of Irish MNEs spoke of the need for an increased level of provision of information by state agencies, particularly in view of the opaqueness of Chinese administration. Also identified was the lack of assigned responsibility to any state body for the provision of assistance or guidance for outward investors. The role played by Enterprise Ireland was acknowledged, but it was pointed out that trade missions do not facilitate investors, nor are potential 'match-making' or feasibility studies offered to investors by Enterprise Ireland, as their core focus is on the promotion of trade.

The importance of trade missions was highlighted by one executive who commented that the MNE's customers 'are very impressed when we can produce a minister for a signing ceremony. They read this as, us having strong government contacts. But this is so much easier in a small country of only four million, compared to China'.

Overall, there was strong support for 'soft' assistance from the state. The divergence in views between large and small MNEs can presumably be accounted for by the fact that large MNEs enjoy considerable access to local authorities and have sufficient strength to resolve issues by themselves.

Investors in Eastern Europe

The industrial sectors in which the Irish MNEs operate are financial services, pharmaceuticals, manufacturing, IT and electronics. Three of these areas, financial, IT and electronics, are suggested in the Irish Government's Asia Strategy as areas for strengthening links with China. Hence, the views of executives in these industries are of particular relevance.

Just over half of the MNEs invested in Eastern Europe for market potential opportunities, with the remainder deciding to do so because their customers were investing there. Both of these phenomena were also evident in the case of investors in China, but the focus identified by interviewees in Chineseinvested MNEs was primarily on exploiting market opportunity.

In response to the question as to why they invested in Eastern Europe rather than China, the general response was that China didn't fit in with the firm's business plan at the time of the investment. Asked if they now considered that they should invest in China, all were non-committal. One executive suggested that 'things can be controlled easier close to home. We know the environment'. Another said 'We were facing competition from other European countries and central Europe matched up. We looked at China two years ago. We have no interest in a greenfield site. We are not big enough and don't have management depth'. An executive of a pharmaceutical MNE stated that 'We don't follow low wage economies. In the hi-tech pharmaceutical industry there are a different set of entry principles. In other industries there are low entry barriers, but not in ours'.

The perceptions of the regulatory and cultural environments centered on the lack of respect for intellectual property rights and contract law. An IT executive spoke of his concern about the lack of IPR protection and was not convinced that he could protect his patents through the legal system. A pharmaceutical executive recalled that intellectual property accounts for 80% of the value of the MNE and stated in strong terms that intellectual property is the lifeblood of the MNE so it must be protected (the firm has an in-house team of lawyers for this purpose).
The electronics executive spoke of there being 'no enforceable rights' when the question of contract law was raised. All executives spoke in similar terms, saying that they had no expectation that their intellectual property could be protected by contract law or by the legal system in the event of a dispute. The consensus was that the legal system is not sufficiently mature to enforce their rights. It should be borne in mind that these views are perceptions from a distance, as these firms have no engagement with the Chinese economy.
A financial services executive referred to a strong level of state control in the banking sector in China. When the fact was raised that other international banks have shown an interest in acquiring holdings in the 'big four' Chinese banks, he replied that the maximum shareholding they are being permitted to acquire is 20% at a very expensive price. The Irish financial institution would have an interest in the provision of corporate banking only, if it were to ever consider investing. His perception is that the retail market 'is sown up by state banks'.

The executives interviewed did not express particularly strong views on the cultural dimension of investing in China, which is understandable given their lack of engagement with China. Issues such as cultural difference and corruption were mentioned, but not as insurmountable barriers to investment. The principal barriers identified were regulatory/legal. All interviewees saw a role for diplomatic missions, government-led trade missions and the support of state agencies in assisting entry into the Chinese market. Similar to the views of investors in China, there was support for 'soft' assistance only. The views of executives in this category are not based on direct experience of investing in China. The perceptions offered on IPR protection and contract law corroborate those of executives whose MNEs have already invested in China. Generally, there was little recognition of the potential market opportunity which China offers. However, executives from the same five industries, which have already invested in China and which are included in this research, pointed to the locational advantage which China offers in this respect. It can be assumed that the Irish MNEs which have invested in Eastern Europe possess ownership and internalisation advantages. The size of these MNEs is not dissimilar to that of the Irish MNEs which have already invested in China. Therefore, what factors are inhibiting their willingness to exploit the locational advantage which China offers? The main reason cited is the lack of legal protection for intellectual property, should they invest in China. Accepting that the population included in this category of the research is small, it can be argued that there is an acknowledgement among sections of Irish industry that investing in China exposes a firm to the risk of IPR violation.

Conclusion

There was a clear consensus among both Irish and non-Irish investors in China that the locational advantage which China offers, as understood by Dunning, is market opportunity and this is the principal criterion underlying investment decisions. Of particular interest to our consideration of Barry et al's model is the fact that just over 80% of Irish MNEs are in the traded sector. This research indicates that the current wave of Irish FDI into China differs from the model of Irish outward FDI identified by Barry et al (2003) in the case of the UK and US, and that the hypothesis advanced in this research holds, namely that Irish FDI into China does not conform to Barry et al's model in the case of China. Irish FDI into China was found to be largely in the traded sector and could not be described as disproportionately horizontal.

While just under 20% of Irish MNEs have joint venture structures, the clear preference of investors not to enter into joint venture arrangements with Chinese partners is apparent. Instead they wish to establish Wholly Foreign Owned Enterprises (WFOEs), where they can retain full control of operations. The preference toward the establishment of WFOEs reflects 'the decreasing dependence of MNEs on the Chinese government for marketing support, the diminishing reliance on Chinese partners because of the acquired experience and more entrenched position by the foreign investors and especially the relaxation of the foreign ownership regulations'. (Van Den Bulcke et al, 2003:68) It also reflects the manner in which MNEs wish to exploit the internalisation advantage which they possess. The preference in favour of WFOEs is also important as a means of protecting the MNE's ownership advantage, in the form of intellectual property rights. The risk to IPR and the absence of enforceable contract law were identified as the most significant disincentives to investing in China. These views were supported by Irish investors in Eastern Europe. These disincentives represent a challenge to the ownership advantage of MNEs.

The executives interviewed paint a picture of companies which are taking a long-term strategic approach to investing in China, rather than having a focus on short-term profits. They see their investment as adding value to their global operations, in particular the locational advantage which China offers in market opportunity. However, the challenges associated with investing in China should be borne in mind. At this point, we shall turn our attention to specific consideration of such challenges before presenting views on the nature of and prospects for Irish inward FDI into China.

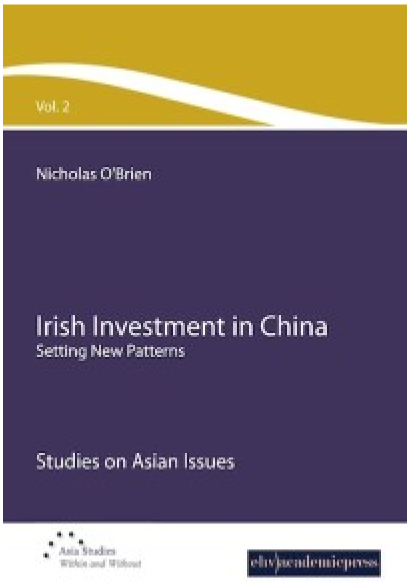
NOTES

[i] The reference to increasing tax refers to a move to harmonise tax rates for foreign and Chinese firms, which is required under WTO rules.

[ii] In the Chinese political system, a Mayor is the public face of local government and manages affairs on a day-to-day basis. However, a Party Secretary de facto out-ranks a Mayor and is responsible for the determination of key policy issues.

[iii] Commissioner László Kovács addressing Consuls General in Shanghai, May 2006

Chapter 4: A Land Of Opportunity And Challenge ~ Irish Investment In China. Setting New Patterns



Introduction
Li and Li (1999: 11) contend that 'for potential foreign investors, a omprehensive understanding of the investment environment in China – including its unique history, culture, political system, socio-economic regime, legal system, infrastructure, and consumer behaviour is essential for the establishment of successful ventures in China'.
This paper will draw together the data generated by this research and identify the locational advantages and disadvantages which China holds for Irish investors. Initially the locational advantage which China offers will be considered as a means of appreciating the opportunity which China offers Irish investors.
This will be followed by a consideration of the locational disadvantages which China poses in the areas identified in the literature and through this research, namely the regulatory, cultural and legal frameworks. The literature review identified the legal framework as challenging, so issues raised in this research, namely contract law and intellectual property rights, will be considered.
Finally the effects of regionalism will be discussed with both locational advantages and disadvantages identified. At the conclusion of this paper we will be in a position to answer the question posed in the sub-hypothesis as to whether or not the business environment in China is different from that experienced by Irish investors in other markets. If this is the case, this analysis will also assist in providing an answer to our prescriptive research question as to the desirability of state involvement in the facilitation of Irish FDI into China.

Locational Advantages which China offers
The literature review points to the considerable advances which China has made in attracting inward FDI since the opening-up policy was introduced in 1979. MNEs continue to recognise the locational advantage which China offers and are seeking to exploit their ownership and internalisation advantages by investing in China.

China's overall record since reforms began in 1979 is dazzling, and its performance is in many ways improving. Annual real GDP has grown about 9% a year, on average, since 1978 – an aggregate increase of some 700%. Foreign *trade growth has averaged nearly 15% over the same period, or more than 2,700% in aggregate. Foreign direct investment has flooded into the country, especially throughout the past decade… The country has developed a powerful combination – a disciplined low-cost labor force; a large cadre of technical personnel; tax and other incentives to attract investment; and infrastructure sufficient to support efficient manufacturing operations and exports. (Lieberthal and Lieberthal, 2004: 3-4)*

Associated with this rapid economic growth is an ever-increasing domestic consumer market. 'Host countries with larger market size, faster economic growth and higher degree of economic development will provide more and better opportunities for industries to exploit their ownership advantages and therefore, will attract more market-oriented FDI'. (OECD, 2000: 11) 'Survey evidence suggests that the main motives for Irish companies investing abroad are to enter new foreign markets and acquire new technologies rather than to lower the cost base'. (Forfás, 2001: 4) This view is supported by this research, with the vast majority of executives clearly identifying the locational advantage which China offers as market opportunity. This research among both Irish and non-Irish MNEs also supports the views of Li and Li (1999), who argue that MNEs from developed economies which invest in China will be attracted by the large and growing consumer market and the significant potential for future development rather than the relatively cheap labour pool which China also offers. We can say therefore that the size and growth of the Chinese economy has been identified by Irish investors as offering a significant locational advantage, within the meaning of Dunning's eclectic paradigm model.

While China has a population of 1.3 billion, the literature indicates that the consumer market is primarily along the eastern seaboard and numbers in the region of 300-350 million. This research supports this finding. This is equivalent to the population of the European Union before the ten central and eastern states joined in 2004. A market of this size in one country, greater than the domestic market of the US, represents a considerable locational advantage. While China's eastern seaboard does not obviously have the purchasing power to be found in developed economies, the consumer market is segmented and growing rapidly. China's upper middle class is not dissimilar to the size of Germany's population, with GDP continuing to grow at close to double digit levels. In this environment of continuing high economic growth and increasing consumer spending power, foreign MNEs see the attractiveness of investing in China. Lieberthal and Lieberthal (2004: 4) give an indication of the magnitude of the locational advantage available to investors in China.

Four to six million new cell phone subscribers are signing up every month. Computer use is spreading more rapidly than in any other country. The automotive market is surging, making China the one place in the coming decade where carmakers can compete for a pie that is growing rather than fight over one that is not. In the early 1990s, almost all retail outlets in China were small shops and wet markets. Now, at least in major cities, hypermarkets are common… Long-term trends in China, moreover, promise continued growth.

The findings of this research support an attitudinal study undertaken among foreign investors in China by Du Pont (2000). In a survey of 100 investors in China, each firm with an investment in excess of USD1 million**[i]**,Du Pont (2000) found market potential to be the prime motivator driving FDI.

	Importance of Factor				
Category	Very	Fairly	Little	Irrelevant	Total
1. Market Potential	53.0	18.5	9.5	19.0	100
2. Low Labour Cost	18.0	25.3	15.6	41.1	100
3. Rich Resources	14.0	32.5	17.4	46.1	100
4. Investment Climate:					
- government policies					
- investment incentives					
- import substitution					
- political stability	6.5	34.6	18.6	40.3	100
5. Others:					
- transportation cost					
- follow the competitor					
- technology transfer					
- weak industry	20.8	32.3	20.4	26.5	100

Source: Du Pont (2000: 186)

Table 1: Determinants of FGI into China

Some interesting data emerges from Du Pont's study. There is a clear identification among investors of the market potential which China offers. Over half of those surveyed (the highest result for any category) identify market potential as 'very important'. This is clearly corroborated by our research findings. Slightly over half see little or no importance in low labour costs. Again, Du Pont's study is supported by this research. Rich resources emerged as relatively important in Du Pont's study but this is not surprising given that the car and cement industries were included. In Du Pont's research, over half see government policies and incentives as of little or no importance. This would seem to indicate that those surveyed are broadly content with the political environment and level of incentives available.

A second reason why MNEs from developed economies are investing, and identified by this research, is that as more MNEs invest, MNEs which have supply contracts with the initial investor must also invest in China in order to protect their supply contracts. This was identified by both Irish and non-Irish MNEs. This phenomenon appears to be particularly prevalent in the electronics industry and is likely to increase in importance in China for two reasons. Firstly, large electronics manufacturers want to gain an increasing share of the domestic Chinese market**.[ii]**Secondly, as more and more firms locate, a critical mass is created, which means that other MNEs in this sector have little choice but to follow. This reason was cited by an Irish MNE which operates in the electronics sector.

China also offers other locational advantages. The OECD (2004) has identified the considerable resources which China has committed to the development of its physical, financial and technological infrastructure, which has resulted in a higher standard than that in many of China's east and south-east Asian competitors. In addition, since China acceded to the WTO it has sought to display an openness to international trade and access to its markets. This is exemplified by the reduction in 'the average level of applied import tariffs from more than 50% in 1982 to just under 10% in 2005. Compared to many developing countries, China's average import tariff is relatively low'. (Bergsten et al, 2006: 81) While the removal of barriers to trade can remove one of the incentives to invest, countries which are more open to trade tend to receive higher levels of inward FDI. (Lipsey, 2000)

Some commentators cite the relatively low cost and productivity of labour as a key locational advantage which China offers. (Although, as indicated earlier, there are significant regional variations in this regard. If an investor wishes to avail of low labour costs, then the centre and western parts of the country are more appropriate then the eastern seaboard.) As a reason for investing, this is not particularly relevant for Irish investors, with only 10% of Irish MNEs citing this locational advantage as a key determinant. Low labour costs are an important consideration for investments from some countries, but not those from Ireland.

The executives who participated in this research referred to the level of incentives available. However, these incentives did not feature prominently in the decision to invest. What was evident was the need for MNEs to locate in a Special Economic Zone to benefit from preferential tax treatment. Also, investing MNEs should be cognisant of the significant inter-regional competition to attract inward FDI. In particular, MNEs in hi-tech industries are likely to receive offers of attractive incentives. Generous land-use permits are one of the most important fiscal incentives available to local authorities. All land is owned by the State and land-use permits grant a 50-year lease in the case of an enterprise or a 70-year lease in the case of a private dwelling. The Detailed Implementation Act of the Equity Joint Venture Law provides that provincial level governments have the power to determine the scale of rent for land-use fees.

Foreign investments are entitled to tax exemptions and reductions e.g. there are tax exemptions for profits for the first two years; 50% reduction for the next three years; and an additional ten years of 15-30% tax reduction for those located in economically deprived areas. The average tax rate for foreign investments is typically of the order of 15%, while indigenous enterprises face a rate of 33%. However, in order to comply with its WTO obligations on non-discrimination, in March 2007 the National People’s Congress announced that corporation tax for all entities, both foreign and domestic, will be amended to 25% for new investments. However, tax breaks will still be permitted in Special Economic Zones. This movement in rates appears to have done little to dampen inward investment. Presumably this is because the economy’s large-scale inward FDI, coupled with the country’s substantial trade balance, has created excess liquidity in the economy.

As the focus of Irish investment into China is the exploitation of market opportunity, changes in the tax code are unlikely to significantly affect the levels of Irish inward FDI. This research found that executives did not place particular emphasis on taxation policies in their decision to invest. This supports the relevant literature, which found that taxation is part of a package of measures which investors find attractive (Moosa, 2002; Agarwal, 1980) and shows that incentives are considered as part of the risk and return considerations. If changes in tax codes are to affect inward FDI, it is likely to be in those industries where low-cost labour rates are the motivating factor behind the FDI. In the case of China, this type of FDI originates mainly in east and south-east Asia.

Overall, Irish MNEs which have invested in China to date conform to Li and Li’s

(1999) categorisation of investment by MNEs from developed economies. They also conform to the general trend in Irish outward FDI, which focuses on market opportunity. (O'Toole, 2007) While accepting the limited nature of this study, it is interesting to note that no significant motivational variations between Irish and non-Irish MNEs included in this research have been found, a fact which lends weight to the view that Irish investment in China appears to conform with investment patterns from other developed economies.

Locational Disadvantages which China Poses

The Regulatory Framework

Luo (2000) contends that the peculiarity of China's economic system generates uncertainties for international firms that operate there. The OECD (2005) calls for significant reforms in public and corporate governance, observing that laws and regulations are sometimes applied in an unsystematic manner and can be skewed by special interests.

It is important to be aware of the developing nature of the Chinese economy and the relatively recent creation of the framework governing FDI. China has put in place a legal and regulatory infrastructure in a relatively short space of time, with institution building starting only in 1979. The Law on Joint Ventures Using Chinese and Foreign Investment, which is also known as the Equity Joint Venture Law, was promulgated in July 1979. This legislation is brief and contains only 15 articles. Since it was sketchy and its wording was vague, it left latitude for divergent interpretations and a lack of legal certainty. Many important operational issues, such as market access, taxation, foreign exchange and land use, were not dealt with or were defined in ambiguous terms. This allowed provincial governments to interpret the law and laid the foundation for the strong inter-provincial competition to attract inward FDI which still exists today. In addition, the name of the Equity Joint Venture Law spells out the investment model permitted in the early stages i.e. only joint ventures between a foreign investor and a Chinese partner.

Between 1984 and 1990 the three most important elements of the enlarged legal framework were the Provisions for the Encouragement of Foreign Investment, the Law on Wholly Foreign-owned Enterprises (the WFOE Law) and the Law on Cooperative Joint Ventures (the CJV Law). The permitted movement from Joint Venture companies to Wholly Foreign Owned Enterprises (WFOE) is significant. Executives included in this research indicated a strong preference for a WFOE structure rather than a joint venture arrangement. These findings are supported by the views of Shenkar (1990) and Teagarden and Von Glinow (1990), both of whom express a high level of performance difficulties in joint venture arrangements. In this study there was a perception that the Joint Venture arrangement existed to serve the requirements of the Chinese partner first and the foreign investor second.

Depending on the size and location of the FDI project, the foreign investor must approach the relevant authorisation agency. China has a three-tiered structure for approval of FDI projects: the central government, provincial governments, and county governments, depending on the size of the financial investment. The State Council (the central government level) has the authority to approve projects above USD 100 million. The State Planning Commission and Ministry of Foreign Trade and Economic Cooperation (MOFTEC) have the authority to decide on FDI projects between USD 30 million and USD 100 million. Provincial governments have the authority to approve projects up to and including USD 30 million; local government (the county level) has the authority to decide on projects below USD 10 million. The OECD (2003: 19) has called for a 'raising of [the] FDI project value limit above which approval has to be submitted to central government departments at national level and increasing the approval powers of local governments accordingly'.

In the evaluation procedure, relevant government agencies have the duty to examine whether the capital subscribed to the project has been assured; whether the proposed project does not require additional allocation of raw materials by the State; and whether the project does not adversely affect the national balance of fuel, power, transportation and export quotas (Implementing Regulations on the EJVL, art 8(1) and (2)). FDI projects are required to promote and benefit the development of China's economy (Implementing Regulations on the EJVL, art 3 and WFOEL, art 3). These requirements indicate the added-value dimension which the Chinese Government requires of foreign investments i.e. that they should bring in advanced technology and equipment or generate foreign currency. It is important for Irish investors to be aware of such regulations as foreign investors are required to set out how they comply with these requirements.

Executives of non-Irish MNEs found the business licence process to be bureaucratic but manageable. Irish investors found the process more challenging, which is understandable given the lack of such requirements in Ireland. Interviewees referred to particular sectoral licensing issues. It can be expected that China will continue to liberalise the investment regime as it continues to meet its WTO obligations. Unless there are issues relating to national security, or the continuity of supply, or there is a natural monopoly, it is difficult to justify sectoral restrictions on FDI. A role exists for state involvement in lobbying for the removal of such restrictions because 'government restrictions on who can do business in which sectors were specifically designed to protect domestic producers from international competition'. (Breslin, 2005: 739)

A regulatory restriction is in place on the availability of capital, but it has to be acknowledged that this is constantly evolving. Local banking systems and equity markets are underdeveloped in China and venture capital is particularly limited. (Khanna, 2005) Foreign currency restrictions were also an issue raised during this research. While China has made moves to liberalise its currency, it is not a freely convertible currency. Investors can repatriate profits but only with the consent of the State Administration for Foreign Exchange. This consent is granted provided one's tax affairs are in order, but delays can be experienced.

Investors should also be aware of particular requirements relating to the transfer of technology. Given the predominantly hi-tech nature of Irish industry,such requirements are of relevance. Borensztein et al (1995) developed a crosscountry regression framework for testing the effect of FDI on economic growth by drawing on investment flow data from industrialised economies to sixty-nine developing economies over a twenty-year period. Their results show that FDI is an important vehicle for the transfer of technology from developed to developing countries. The effects of the conclusion reached by Borensztein et al are evident in the Chinese Government's focus on seeking a transfer of technology when investors are negotiating inward FDI. A potential spin-off of this is an upgrading of local industry. In addition to the transfer of technology, there is an expectation that the transfer will lead to an increase in social capital skills. The effect of this policy was made clear by the executive of the automotive MNE, which had in effect to double its anticipated level of investment by installing the most up-to-date technology in its manufacturing plant. The requirement to affect a transfer of technology can have adverse implications for an MNE's ownership advantage if sufficient precautions are not taken to protect intellectual property rights. (See below for a discussion of this issue.)

In summary, the regulatory regime can be described as complex but by no means impossible to deal with and, as such, cannot be described as a significant locational disadvantage. However, as will be argued below, the regulatory requirements regarding the transfer of technology combined with the lack of protection for intellectual property rights represents a potential threat to an MNE's ownership advantage.

China's Culture

Culture can be a form of location-specific disadvantage within the context of Dunning's eclectic paradigm and has the potential to dissipate other location specific advantages. While China is in rapid economic transition, it still has a strong cultural heritage. 'Although the history of China has been marked by periodic upheavals, its majority of Han people have experienced the longest span of homogenous cultural development of any society in the world… Since the Chinese culture and social structure are very different from the western world, it is essential for potential investors in China to develop a comprehensive understanding of these differences'. (Li and Li, 1999: 130)

With China's 5,000 years of civilization history, Chinese culture, tradition, and its value system have a significant impact on the operations of all Chinese businesses, as well as on joint ventures. (Yin and Stoianoff, 2004) Li et al (2001) argue that foreign investors can encounter problems not only of an institutional nature but also informal constraints such as culture and ideology. In this regard Yin and Stoianoff (2004) contend that an understanding of Chinese social and cultural background is necessary for foreign investors because it can help them to handle the differences in Chinese society. The core of Chinese culture is directly related to Confucianism**[iii]**and the key traits of Chinese culture emphasise relationships, face saving, and reliance on the group. Although formal laws and regulations have always existed in traditional Chinese society, they could be amended to favour people in different situations. In order to obtain such a favourable amendment, Chinese culture has formed a special institutionalised system of personal relationships called guanxi. Traditionally, guanxi was used as an alternative path to formal bureaucratic processes and procedures. Guanxi operates both within and outside the official economy and involves the cultivation of personal networks of mutual dependence and trust. (Yang, 1986; Smart, 1993)

China's cultural uniqueness and the role of guanxi were exploited in the early phase of the reform process, when much of the FDI came from countries or regions that have large overseas Chinese populations, notably Hong Kong, Macao, Taiwan, and Singapore. This wave of FDI was focused on the Pearl River Delta (the hinterland surrounding Hong Kong) and Xiamen. A strategic decision was taken to exploit this relationship.

'[T]he predominance of Hong Kong investment in China may be largely due to use of guanxi and the dramatic reduction in costs that it facilitates (Smart and Smart, 1991)'. (Jones, 1994: 201) Overseas Chinese from Hong Kong and Macao have a similar dialect and culture similar to those to be found in the Guangdong Province. Jones (1994) points to a general cultural preference for relational rather than formal legal and impersonal ties, which is shared by both mainland and overseas Chinese, and which has practical economic effects.

[T]he Chinese economy is still characterised by undeveloped market structures, poorly specified property rights and a weak production market. In this situation, the guanxi network often substitutes for government instituted, formal channels of resource allocation and dispersal. (Luo, 1998: 173)

Davies et al (1995) point to the importance of business networks, arguing that they enhance comparative advantage by providing access to the resources of other network members and are particularly important in respect of market entry. This research found that the executives of MNEs recognise a particular cultural environment in China and its distinct attributes. Even in the advanced Yangtze River Delta region, the executives spoke of a quasi-normal cultural milieu but also spoke of the need to develop strong relationships with relevant government officials. It was recognised that the level of relationship required in China extends beyond that normally encountered in the West. Executives spoke of the need to develop stronger guanxi links the further one goes from the eastern seaboard region, which represents a regional variation in the conduct of business affairs. Overall, the view presented was one where stronger relationships are required than Western business people are traditionally accustomed to. This research also corroborates the view of Macauley (1963) that relationships are central to business transactions. His views on the importance of honouring one's commitments and the perceptions of the individuals within one's industry are particularly relevant given the importance of not 'losing face' in Chinese culture.

An observation made by several interviewees was that one of the most important barriers to the development of guanxi by foreign businesspeople is the Chinese language. This view is supported by Bjorkman and Kock (1995), who point out that, while western businesspeople take part in discussions with their Chinese counterparts, it is impossible to develop a personal relationship as they do not speak the language. While some foreign business people speak Mandarin, they tend to be in the minority.

Guthrie (1998) argues that perspectives on guanxi vary directly with a firm's position in the industrial hierarchy: the higher a firm is in the hierarchy, the less likely the firm is to view guanxi practice as important; the lower a firm's hierarchical position, the more likely it is to view guanxi practice as important to its success. The reason for this is that firms in the higher levels of the industrial hierarchy already have privileged access to those with whom they have to deal, which they derive from their economic strength e.g. they have easier access to resources, and already have a strong relationship with the relevant government economic agency. Firms with a lower hierarchical position cannot enjoy similar privileges. This view is supported by this research. Those from particularly large MNEs did not place particular emphasis on guanxi or building strong relationships. This is to be expected as, given the economic importance of the MNEs concerned, they presumably enjoy easy access to senior officials. When the author asked further questions about this, one executive replied that 'We have a very smooth relationship with the local government'. It can be deduced that executives associated with large-scale foreign investments are likely to enjoy high-level access to local authorities and are somehow granted guanxi by virtue of the scale of the investment.

Guanxi also poses certain risks to a firm. Employees' personal networks may become liabilities when they return favours from guanxi contacts, whether within the firm or at competing firms. (Van Honacker, 2004) To obviate this threat, MNEs should seek to bring transparency to relationships and prevent conflicts of interest from developing. Guanxi can also be disrupted by staff mobility. When a staff member leaves an MNE the nature of relationships with third parties may change because the former employee had constructed relationships with customers and suppliers. Given the difficulty associated with the retention of staff, as identified by this research, this is a dimension which foreign investors should be aware of and see as a potential locational disadvantage. Van Honacker (2004) proposes a team-based selling approach to avoid customer contacts being concentrated on a single individual, but such an approach may not always be practical.

This research points to a strong cultural milieu in China, which a foreign investor must be cognisant of. The importance of building strong relationships was acknowledged by interviewees, in particular the need to build relationships with relevant officials. While this can also be of importance to business people in the West, it is probably fair to say that it is only of particular importance in regulated industries. The need to develop such relations in China is a cultural divergence from the business situation in the West and one which needs to be taken into consideration by investors. Those who have invested away from the developed eastern seaboard spoke of the need to develop traditional guanxi relationships. As argued above, China's cultural environment can become a locational disadvantage within the context of Dunning's model if due account is not taken of the cultural variations which exist. Accordingly, China's cultural environment can be seen as presenting unique challenges which Irish investors would be unaccustomed to and which they should take into consideration.

Given the large-scale level of foreign investment and the introduction of Western business practices, the question has to be asked as to whether the unique Chinese culture and guanxi will persist. Arias (1998) argues that the economic and structural conditions that make guanxi relevant for conducting business in China are changing. While this research identified a regional variation in the intensity of guanxi, it was found that, executives continue to place an emphasis on the development of relationships even in economically developed regions. A study by McGrath et al (1992) found little breakdown of traditional Chinese cultural values in Taiwan, despite fifty years of exposure to western business practices. McGregor (2007) points to a resurgence in Confucianism, with the implicit approval of the Chinese authorities. He argues that this revival fits comfortably into the Communist party's effort to reframe its single-party rule as part of a long-standing tradition of benevolent government. The influence of China's culture is likely to remain an important component of doing business in China for the foreseeable future. Failure to take account of cultural norms is likely to lead to an increase in transaction costs in terms of the time spent in negotiating unnecessary obstacles.

Jones (1994) poses the question of whether or not the persistence of guanxi means that Chinese society is resistant to the globalisation of the Rule of Law. 'This may indeed be the case, but we should also note that globalisation has singularly failed to eliminate cultural networks (such as "old boy" connections) from Western capitalism' (Jones, 1994: 204). Accordingly, it is to the issue of the Rule of Law that we shall now turn our attention.

Contract Law

Macauley (1963) identifies the relative unimportance generally attached to contracts in the business world as emanating from an understanding on both sides of an agreement as to the nature and quality of a seller's performance and the value of the relationship underlying the transaction. This research has identified an apparent paradox among Irish and non-Irish investors alike as to their views on the use of contracts in China. On the one hand they seek to negotiate contracts with a greater level of detail than they would do in the West, with provisions on obligations and penalties set out in a forthright manner, and on the other they recognize the general non-enforceability of contracts. One executive, though, spoke of his opposition to agreeing contracts with suppliers. His reluctance accords with the view of Graham and Lam (2003), who state that trust and harmony are more important to conducting business in China than having a legal contract.

Why is there an apparent paradox in the views of executives? Perhaps it emerges from the underdeveloped nature of law in China, as identified by one of the lawyers. He suggested that in developed economies the law can interpret intentions, whereas there is no developed body of case law in China. Therefore, foreign MNEs may be attempting to create comprehensive contracts so that, should a dispute emerge, they can point to the clear and unambiguous detail of the contract. However, there are two difficulties with this approach. Firstly, as identified by executives, the likelihood of obtaining a satisfactory outcome in the courts is not great. Secondly, as identified by one of the lawyers and several executives, contracts are ultimately linked to relationships. This research supports the view of Macauley (1963) that the ultimate non-legal tie is the maintenance of a successful relationship. However, this research is at odds with his assertion that business people are reluctant to engage in negotiating contracts. The research tends to support the view of Jones (1994) that a distinctive form of capitalism has developed in China, dominated by the Rule of Relationships rather than the Rule of Law.

This research provides evidence to support Jones' (1994) view that China may be the 'fifth little dragon' in Asia, which demonstrates that the persistence of guanxi is not contradictory to the logic of capitalism. It also supports her observation that guanxi and relationships provide an alternative mechanism to the Rule of Law in China. This is not to state that China is a legal wasteland. Rather, this research shows that a 'full legal order' is absent and investors must place considerable emphasis on building strong relations with officials and business contacts.

This research also identifies the difficulty of enforcing contracts, which emanates from the lack of a tradition of resorting to court proceedings to oblige a party to fulfill contractual obligations. And it identifies the importance which executives place on approaching the executive branch of government in seeking to resolve disputes. One lawyer spoke on several occasions of using this route and expressed a preference for liaising with government at a provincial rather than at a local level. This approach flies in the face of the concept of the separation of powers, but Deng Xiaoping, the architect of the opening-up policy, never envisaged such a separation of powers. Perhaps, then, one should not be surprised that there is no strong tradition of the Rule of Law in China.

'In the final analysis trust and harmony are more important to Chinese businesspeople than any piece of paper. Until recently, Chinese property rights and contract law were virtually non-existent – and are still inadequate by western standards. So it's no wonder that Chinese businesspeople rely more on good faith than on tightly drafted deals'. (Graham and Lam, 2004:45) It is unlikely that the current legal framework will alter significantly in the short term, but that the situation will continue to improve incrementally.

Within the context of Dunning's eclectic paradigm, the absence of the Rule of Law represents a locational disadvantage for Irish investors. Irish MNEs, in common with other firms in the West, do not place considerable emphasis on the negotiation of contracts when conducting business in the West. (Macauley, 1963) However, this research has identified that they do negotiate detailed contracts when conducting business in China. This represents a cost to the MNEs in terms of legal fees. A picture emerges of the need to build a strong network of relations and in the event of a legal dispute, adequate redress is more likely to be obtained in this manner than through legal channels.

Intellectual Property Rights
In 1979 virtually no legal protection was offered to intellectual property rights.

Since then, legislation on trademarks was enacted in 1982, on patents in 1984, and on copyright in 1990. 'China's intellectual property rights protection, although strong in theory, are in fact almost impossible to enforce in much of the country'. (Lieberthal and Lieberthal, 2004:15) This research found that executives express concern at the lack of respect for IPR. These findings are supported by IBEC (2006: 3), which found that 'the lack of intellectual property protection continues to be viewed as a significant barrier to trade in China and also, to a lesser extent, in some other Asian markets such as India and South Korea'.

Within the context of Dunning's eclectic paradigm, the lack of respect for IPR raises issues in respect of all three advantages. The absence of legal protection is a locational disadvantage which China poses for investors. Peerenboom (2002) points to evidence that suggests that the lack of the Rule of Law and clear property rights have already taken a toll and will become an impediment to future investment and growth. 'Anecdotal evidence confirms that some companies were scared away or chose to minimise their investment or to deliver second-grade technology rather than the most up-to-date technology'. (Peerenboom, 2002: 474) This view was evident in the case of the food sector MNEs. A chemical sector MNE executive was opposed to the introduction of the firm's latest technology into China, given the previous experience which the MNE had suffered.

This IPR issue also creates a risk for the ownership advantages which MNEs possess. Intangible assets, including technology or patents, are of central importance for MNEs. (Markusen, 1985) Due to the lack of the strict enforcement of patent and trademark laws in China, the transfer of advanced technology is a concern for MNEs. Du Pont (2000) identifies reluctance on the part of MNEs to transfer technology due to the 'copycat phenomenon'. Such a view is corroborated by the findings of this research.

Internalisation advantage refers to the manner in which the MNE organizes its activities in third-country markets. A legal system that protects intellectual property rights can create confidence in the use of independent subcontractors; while in the absence of protection, the MNE will tend to internalise production. Buckley and Casson's (1976) internalisation theory contends that the protection of ownership advantage is a reason to retain production within the firm. Multinationality, therefore, can be a response to weaknesses in a legal system. This view is evident in the reluctance of executives to enter into joint venture arrangements because of the potential leakage of intellectual property to a competitor. While the use of a joint venture arrangement or M&A can hasten entry into a third country market, the findings of this research indicate that the use of either mechanism poses challenges in the case of China.

While executives from Irish MNEs which have invested in Eastern Europe have little direct experience of investing in China, the threat to the MNE's intellectual property was cited as giving rise to a general reluctance to invest in China. One executive spoke of little hope of redress should such violation occur. He asserted that intellectual property is the core ownership advantage which the MNE possesses. Should this be compromised, it could have significant adverse implications for the MNE. The MNE was therefore unwilling to invest in China despite the market opportunity which China represents.

Another executive stated that the MNE would approach the executive arm of government should IPR violations occur. This reinforces the notion of the importance of guanxi and the under-developed nature of the legal system. In summary, it can be deduced from this research and the relevant literature that the lack of respect for intellectual property rights and the associated challenge of obtaining suitable redress through the legal system pose a potential locational disadvantage for investors.

In a professional capacity, the author has attended briefings in Shanghai's High Court on the judicial efforts taken to protect the intellectual property rights of MNEs. Despite the efforts of the authorities, the evidence from senior executives is that counterfeiting continues. It is probably fair to say that it is becoming more controlled in the larger population centres, but such manufacturing would appear to continue, particularly in Guandong Province. It is in the long-term interest of the Chinese authorities to address this issue.
'Addressing IPR issues more effectively will enable China to attract more long-term investment, especially in high-tech areas where technology transfer is more likely to occur in an environment in which IPRs are well protected. It will also encourage domestic creativity'. (OECD, 2003: 28)

Corruption and the Giving of Gifts
It is fair to say that corruption exists, to varying degrees, in all economies, both developed and developing. There is little information available on the level or scale of corruption in China. Had corruption been a major pre-occupation, it is fair to say that it would have been reflected in the interviews particularly with the

non-Irish MNEs, because US companies (some of the non-Irish MNEs included in this research fall into this category) are subject to the Foreign Corrupt Practices Act, 1977 (FCPA). The FCPA could be described as a reflection of the basic principles of Western business ethics, which seek to separate business dealings from the government officials with jurisdiction over those dealings. Breaches of the FCPA can have serious consequences for MNEs with American headquarters, even when the corruption takes place in a foreign subsidiary.
One should not confuse corruption with the necessity to offer a gift on meeting a new client for the first time. Gift giving is an important dimension of Chinese culture and it is expected that gifts will be offered. The etiquette of gift exchange distinguishes it from bribery and corruption. (Smart, 1993) 'In bribery, the two parties enter into an impersonal relationship, linked by mutual materialistic utility. Such manipulative exchanges are geared up to shortterm immediate gain. Guanxi, on the other hand, is geared towards the cultivation of long-term mutual trust and the strengthening of relationships'. (Jones, 1994: 205) Jones (1994) points out that if foreign investors do not appreciate the role of guanxi, they will offer gifts as bribes. 'On the other hand, long-term relationships of trust can help investors resolve problems faster, cutting through red tape and assisting with long and complicated negotiating procedures'. (Jones, 1994: 205)

Looking to future legal developments, Economy (2004: 98) argues that middle-class Chinese will want effective legal institutions to protect their newfound assets. She suggests that the new focus on home-ownership will assist in the development of the Rule of Law. Recognising the absence of a Weberian concept of law in China, Peerenboom (2002) develops a theoretical framework which argues that China is in transition from 'Rule by Law' to the 'Rule of Law'. However, the version of the 'Rule of Law' which China will develop will most likely not be a liberal democratic version of the Rule of Law as it is found in Western economies. He proposes that one needs to bear in mind the differences in political and economic institutions and in cultural practices and values. He suggests that it is possible that China may develop an alternative to the Rule of Law concept as understood in the West and instead what may emerge is a form of the 'Rule of Law with Chinese characteristics'.

However, even the creation of a culture of the 'Rule of Law with Chinese characteristics' cannot be achieved in a short period of time. The OECD (2003: 16) suggests that China 'is striving to develop an impartial and effective court system, but, for institutional and manpower reasons, this work will take years, rather than months, to achieve'.

Regionalism – Advantages and Disadvantages for FDI

Even within China there are regional locational advantages and disadvantages to be considered within the context of Dunning's eclectic paradigm. While an observer might consider China to be a homogenous unitary state, the de facto situation is that provincial governments have considerable devolved powers. Defence and foreign policy are the preserve of central government, but most other matters fall within the competence of local legislators. Mo (1997) contends that, in the area of FDI, local regulations often seek to fill the vacuum left by national legislation or supplement national laws in areas where they are silent. Eng (2005: 5) argues that 'China's rapidly changing environment makes it difficult for the central government to maintain regulatory uniformity across the land. Therefore, local rules could be at odds with those promulgated by the central government in, for instance, bank lending, consumer rights, factory operations and environmental protection'.

In transiting from a command economy to 'socialism with Chinese characteristics', there was a decentralisation of decision-making power. This evolution not only increased enthusiasm for for eign investment at the local level, but also led to understandable competition between competing provinces and municipalities. 'The fastest way for a leader at the local level to rise to a higher position is to oversee successful economic growth in the locality… this has produced a lot of de facto flexibility and initiatives at all levels, even in an authoritarian system with a socialist planning heritage'. (Lieberthal and Lieberthal, 2004: 15) It is important, therefore, to take cognisance of local regulations when considering the locational advantages which each province or municipality can offer. Indeed, incentives also vary at sub-municipal level. It is worth recalling a previously-used example on this point. One of the executives interviewed described his experience of negotiating with officials at district level in Shanghai when considering a location for a corporate headquarters. Given the prestigious nature of the MNE, local officials were keen to win agreement on locating the headquarters in their particular district (the local authority level). The result of these negotiations was that the firm effectively built their headquarters at little or no cost, when the additional fiscal incentives on offer were taken into consideration.

Investment has not been spread uniformly across China, with significant regional imbalances in FDI trends. Zhang (2002) points out that in the period 1983 to 2002 the eastern region of China received almost 88% of the overall FDI in China, the central region 9%, and the western region only 3%.**[iv]**In addition, the center of China's FDI absorption has moved from the Pearl River Delta to the Yangtze River Delta. Du Pont (2000) identifies three distinct investment areas in the country: the four special economic zones favoured in the experimental period, the fourteen Open Coastal Cities, the three Open Economic Zones established in the Gradual Development Period, and the inland provinces, which he describes as requiring attention in terms of their economy and infrastructure. It is not surprising that investment is skewed in favour of the eastern seaboard. The reformers targeted China's coastal areas in the early phases of the opening-up policy as the appropriate destination for inward FDI. Indeed, in the early phase FDI was permitted only in specially designated zones in this region. Regional variations are also evident in consumer purchasing power and income levels. 'The average income in poorest Gansu or Guizhou is only less than 1/8 of that in the richest Shanghai or Guangzhou, and the gap is getting larger'. (Wang, 2006: 47) The east coast is where the highest income levels are to be found. Household size in the cities is 3.1, whereas it is 5.6 in rural areas, pointing to higher levels of disposable income in urban areas.

Investors from Ireland are more likely to select a location in the coastal region as this is where market opportunities are to be found. Another reason why Irish MNEs would be likely to focus on the eastern seaboard is the sectoral composition of the investment, with the emphasis likely to be on hi-tech, service or complex manufacturing sectors. These are predominately to be found in this region. In addition, if the investing firm is supplying another MNE which has invested in China, this MNE is also likely to be located in the coastal region. This view is supported by the National Council for US-China Trade (1990), which found that production bases for labour-intensive industries are shifting from coastal to inland regions.

This research found that the executives of Irish MNEs have identified regional locational disadvantages which one should be aware of. The executives spoke of the need to develop stronger guanxi links, the further one travels from the eastern seaboard region. Referring back to our earlier discussion on the legal system, Clarke (1995) points to considerable difficulties in having court judgments enforced in civil and economic cases. He points to the problem which 'local protectionism' poses, whereby local governments want to protect local enterprises. This problem was cited by one executive, who referred to particular problems when seeking to take legal action outside the province where its manufacturing facilities are located.

Although the Chinese Government has called for an increase of FDI in the central and western regions of the country, the flow of FDI to these areas still lags far behind that directed towards the coastal region. (Luo, 1998) While there have been high profile investments, Breslin (2005: 750) contends that the 'much vaunted "look West" strategy aimed at encouraging more investment into non-coastal areas has largely failed to pull in significant new investors'.

Therefore, in considering an investment in China, Irish MNEs should take cognisance of the regional variations and seek to exploit regional locational advantages. If the object of the investment is to exploit market opportunity, then the eastern coastal region is where the highest disposable income is to be found. Also, when negotiating incentives, one should be aware of the differing levels of incentives available. This, of course, will be related to the nature of the investing MNE, with a premium placed on hi-tech MNEs.

Conclusion

It is generally agreed that increased knowledge of a foreign country reduces both the cost and the uncertainty of operating there. (Buckley and Casson, 1985) Irish investors need to be aware of potential challenges and include them in their business planning. Some are capable of rectification while others are more difficult to ameliorate. It is important that investors recognize that they are not conducting business in a developed economy and include contingencies to overcome obstacles.

This research has identified the principal locational advantage which China offers for Irish investors as being market opportunity. The overall experience of Irish MNEs could be described as very positive. While they recognise the existence of locational disadvantages they are keen to exploit the market opportunity which China offers.

Several locational disadvantages were identified, the most significant being the lack of protection for intellectual property rights. This is of importance for Irish MNEs given the general hi-tech nature of Irish industry. Failure to protect ownership advantages through the utilisation of appropriate internalisation advantages could place the ownership advantage of an Irish MNE at risk.

We can conclude that our sub-hypothesis holds and that the business environment in China is different from that experienced by Irish investors in traditional destinations for Irish outward FDI, particularly in the legal domain. Therefore, it can be argued that market imperfections exist, which distort the operation of the market, with a role existing for the state in removing such obstacles.

NOTES

[i] The firms surveyed were in four industries: agricultute, food-processing, car manufacture, and paper and cement.

[ii] Announcing a US2.5 billion investment in Dalian, north-east China, on 27 March 2007, Chief Executive Ortelli of Intel cited the increasing market opportunity which China represents as a key consideration underlying the multinational's investment.

[iii] The teachings of Confucius (551-479 BC) have moulded Chinese civilisation. His teachings were the officially recognised imperial ideology for over 2,000 years, from 136 BC to 1905 AD.

[iv] The Eastern region of China includes Beijing, Tianjin, Shanghai, and the provinces of Hebei, Liaoning, Jiangsu, Zhejiang, Fujian, Shandong, Guandong, Guangxi and Hainan. The Central region of China includes the provinces of Shanxi, Inner Mongolia Autonomous Region, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. The Western region of China includes Chongqing and the provinces of Sichuan, Guizhou, Yunnan, Tibet Autonomous region, Shanxi, Gansu, Qinghai, Ningxia and Xinjiang Uygur Autonomous Region. Hong Kong, Macao and Taiwan are not included.

Previously published in: Nicholas O'Brien – Irish Investment in China – Setting New Patterns. Amsterdam, 2011