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Institutional Complexity and the Strategic Behaviors of SMEs in Transitional Environments

Introduction

Changes in organizations' strategic orientation in response to institutional changes have been the subject of study in strategy and organization theory for many years (DiMaggio and Powell, 1983; Oliver, 1991). Subsequent studies shifted their attention to how organizations respond to large scale changes in countries that are in transition from centrally-planned to market-driven economic systems - for example, Hoskisson et al. (2000); Peng (2002, 2003, 2004); Tan and Litschert (1994); Tan and Tan (2005); Peng et al. (2008); Peng et al. (2009). These institutional transitions present valuable opportunities to observe firm level strategic changes as they unfold (Li and Peng, 2008) and "present a fascinating opportunity to integrate institutional and strategic choice perspectives" (Peng, 2003; see also Ahlstrom and Bruton, 2010).

More recently, in addition to the scale of institutional change, its complexity has been the subject of study (see Greenwood et al., 2011). Greenwood et al. (2011) propose that complexity is a function of the number of institutional logics and the degree of compatibility between them. Further, they argue that institutional pressures do not permeate all fields to the same extent nor are they experienced uniformly across firms within a particular field. Rather, firms make sense of institutional pressures through

“organizational filters”, which are a function of their own attributes, such as size, field position, governance and identity.

China presents a unique institutional context in which to study the changing strategic behaviors of firms. First, China has seen the emergence of a large number of private enterprises since the early 1990s that operate in competitive industries within fast changing socio-political and economic contexts; according to He (2009), there were 37 times as many private firms in 2004 as there were in 1990. Second, the sustained economic growth of such a large economy in the three decades since the liberalization process began in China in the early 1980s is unparalleled in economic history. According to Summers (1992), “It may be that when the history of the late 20th century is written in a hundred years the most significant event will be the revolutionary change in China.” Therefore, understanding how institutional norms have influenced this success is a matter of great interest to policymakers and managers.

In Table 1 we have unpacked the sweeping institutional changes in China since its Reform and Opening Up policy began in 1978.

Insert Table 1 about here

The research question we seek to answer is - why do SMEs develop particular forms of strategic behavior during periods of major macro-level institutional transitions? We

focus our attention on private SMEs. While previous studies have examined the strategic responses of state owned enterprises (Tan and Litschert, 1994; Xu and Shenkar, 2002; Tan and Tan, 2005) and collective enterprises (Tan and Litschert, 1994) to institutional change in China, there is a paucity of studies on how private organizations adapt to such changes (see Lim et al. 2010 for a multi-country study).

Through our rich fieldwork covering a 12 year period, we attempt to make a contribution to the emerging and promising stream of literature on institutional complexity. The remainder of this paper is organized as follows: we first outline the institutional changes in China with a special focus on the post-2000 period. We then review the literature on institutional changes in transitional (from centrally planned to market) economies, institutional complexity and organizational filters, and how they impact firm behaviors, in particular the choice between related diversification, unrelated diversification and focus on existing business. We subsequently outline our research methods, before proceeding to discuss our key findings and contributions. We conclude with some limitations of our study and suggestions for future research.

Literature review

The institutional perspective

As Xu and Meyer (2013) note, institutional theory brings context into the study of firms (see also Meyer and Peng, 2005; Peng et al., 2008) by suggesting that conformity to the prevailing rules and belief systems enhances the survival prospects of organizations (Scott, 1995; Greenwood and Hinings, 1996; DiMaggio and Powell, 1983; Meyer and Rowan, 1977). While this theory has received empirical support in relatively stable and efficient environments, it is less able to explain and predict firm level behavior in

transitional environments characterized by complexity and multiplicity of institutional demands (Greenwood et al., 2011). Thus, Greenwood et al. (2008) note that much of the institutional research takes an oversimplified approach, treating the institutional context as “out there”, rather than as something with which organizations interact and thus construct. Prior research has largely ignored the diversity and the complexity of the institutional context.

Firm-environment co-evolution

Scott's (1998) open system view suggests that organizations are not only influenced by their environments but manage, negotiate, create and construct them (Suhomlinova, 2006). The two way interaction between organizations and environments has been widely acknowledged in the literature (Baum, 2002; Lewin and Koza, 2001; Volberda and Lewin, 2003; Peng, 2003; Tan and Tan, 2005; Suhomlinova, 2006). Suhomlinova (2006) suggests that transitional environments may be particularly appropriate to study the co-evolution of organizations and environments, for two reasons: i) the history of central planning and the systemic nature of the reforms bring to the fore the vertical connections, both formal and informal, between the state and the private sector; and ii) the transition from centrally planned to market economies tends to redefine the boundaries of firms and firm populations (at the industry and field levels).

Institutional logics and institutional complexity

To address this neglect, researchers have increasingly recognized that complexity of the institutional context is critical to better understand and predict the pattern of organizational behavior. Organizational populations are subject to variations in institutional logics, defined as “the socially constructed, historical patterns of material

practices, assumptions, values, beliefs and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality (Thornton and Ocasio, 1999: 804). The number of prevailing logics and the degree of compatibility between the logics constitutes institutional complexity (Greenwood et al., 2008).

For example, Thornton and Ocasio (2008) examine how “ideal type” institutional logics play out in organizational fields, specifically in the professions such as public accounting firms (fiduciary versus corporate logics), architectural firms (aesthetic versus efficiency logics) and higher education publishing (editorial versus market logic) (see pages 128 and 129). The logics we discuss in the paper are at the macro-level; we explore how the logic of a socio-political and economic system shifts as it transitions from a planned to a marketized system. Whereas studies in the West have examined tensions emanating from a plurality of logics at the organizational field level against a backdrop of stable (though not necessarily singular) macro-level logics (see Reay and Hinings, 2009; Smets et al., 2015), our study examines the impact on firms of major shifts in macro-level logics.

Institutional complexity varies over time. Greenwood et al. (2011) further point out that organizational behavior and choice are impacted by the degree of institutional complexity, because the degree of specificity of the institutional context is linked to the scope of organizational discretion. However, current studies have not paid sufficient attention to the relationship between institutional complexity and organizational discretion in decision-making. The question of why firms do not respond uniformly to

institutional pressures in spite of facing a uniform ‘choice-set’ (Greenwood and Hinings, 2006) has been inadequately studied.

Based on the existing literature, two reasons contribute to shifts in firms’ strategies. First, institutional pressures can vary across organizational fields and are not stable over time (Greenwood et al., 2011). Second, institutional pressures do not affect all firms equally (Greenwood et al., 2011), i.e., there are multiple organizational filters that influence how individual firms frame institutional pressures and respond to them.

Recently, Greenwood et al. (2011) have argued that the attributes of the firm itself, the “organizational filters”, such as its field position, firm structure, governance, and identity, frame how firms experience institutional pressures and how they perceive and construct the repertoire of responses available to them. These arguments suggest that the nature and extent of institutional complexity together with the attributes of firms influence their strategic behaviors.

Institutional complexity in transitional economies

Previous institutional research has rarely put an emphasis on institutional changes over time and firms’ responses to these changes in the context of emerging economies. Tan and Tan (2005) referred to the institutional context in China during its transition period from the early 1990s to 2005 as “hybrid” (see also Rawski, 1995), and noted that it is characterized by the co-existence, competition, and struggle between two competing systems (centrally planned economy and market-oriented economy). This hybridism is the result of the gradual process of reforms introduced by Chinese policymakers, in contrast to the discontinuous process that was followed in Russia (Rawski, 1995; Tan and Tan, 2005). This has meant that for significant periods of time, lasting several years,

characteristics of the centrally planned and market-oriented systems have co-existed in China. The co-existence is both temporal (i.e., at different points in time, the economy finds itself in different stages of transition, with the general movement towards market-orientation) and sectorial (i.e., some sectors, such as textiles and toys, have experienced faster transitions than others, such as banking and power generation). This hybridism pits the logics of the two institutional forms against each other and creates uncertainty for organizations.

In terms of the specific behaviors that we are interested in, Guthrie's (1997) work on Chinese organizational responses to institutional transitions suggests that firms will tend to set up new businesses as an uncertainty mitigation mechanism. Owners of firms might fear that their current resources and future profits in existing businesses might be under risk from unpredictable governmental policies, which might lead to greater competition or more stringent fiscal regulations in the future. They may therefore hedge their bets by investing their surpluses from existing businesses in different sectors. According to He, 2009,

“To hedge the risks of rule changes and a weak legal environment for the protection of private ownership, the strategies and business models pursued by these entrepreneurs tend to be short-term oriented, diversified in various economic sectors, and built on tightly-bound trust networks.” (He, 2009: 48).

Another argument offered to support the greater likelihood of diversification in a period of institutional change is that of “institutional voids” (Khanna and Palepu, 2000; Leff, 1976, 1978). According to this argument, since transition economies are typically characterized by insufficiently developed institutions needed to support the efficient

functioning of markets (Puffer et al., 2010), established firms that have already built up resource bases and political connections see opportunities in stepping in to fill these voids. Khanna and Palepu (2000) explain that this is the reason why there is a greater number of successful large conglomerates (business groups operating in several unrelated businesses) in developing rather than in developed countries. Our paper examines an underexplored area in the firm-institutions co-evolution, namely firm behaviors at intermediate stages of transition to a market economy, when neither the planning nor the marketization logic is dominant.

Methods

In this study, we build an explicit dynamic perspective into strategic behaviors by looking at our sample of firms over the 2000 to 2012 period. This evolution of the firms' strategies over the twelve-year period can be best captured through an in-depth, case study approach. Very few studies of SMEs in China had used case based qualitative methodologies as of 2006, when we started our fieldwork. This is because most previous studies have been interested in understanding the performance implications of new entry vis-à-vis a focus on existing businesses. We chose to focus as much on the "why" as on the "what" question. Therefore, at the data gathering stage, we documented in detail what strategic changes had taken place in the Chinese manufacturing firms and why they had taken place. We examined both internal and external factors as drivers of the changes.

For selecting cases for this study, we focused our attention on five manufacturing firms that were wholly Chinese owned, because subsidiaries of foreign firms have been shown to follow strategies and management techniques defined by their parent companies (Firth, 1996; O'Connor et al., 2004). We decided to focus on medium sized

manufacturing firms, because we reasoned that micro and small enterprises, as a result of being focused on survival and with a high degree of informality in their management practices, would not provide rich case studies of the phenomenon of strategic change that we wanted to study. We chose to focus on the manufacturing sector as it has been the one that has propelled China's economy in the post-1978 Reform and Opening Up period.

Our research design required the full cooperation of the sample firms. They had to be willing to be interviewed multiple times and provide access to some confidential business information. Therefore we had to select firms on a voluntary basis. After a call for volunteers among the alumni network of one of China's leading business schools, we received replies from a dozen firms willing to participate in our research project. We selected five firms, based on their industry (manufacturing), location, size and ownership. To limit contextual variation and to control for province-level influences, we chose only firms located in the Yangtze River Delta. After thirty-years of economic Reform and Opening Up in China, the Yangtze River Delta region (Southern Jiangsu, Shanghai and Zhejiang) is known for the quality of its institutional environment (less corruption, high administrative efficiency and strong legal enforcement) (Fan and Wang, 2004). Given this institutional background, we assumed that the major strategic changes we observed in firms would be mainly driven by business rather than political considerations.

In spite of having a considerable number of employees, we checked to ensure that in all five firms decision-making was centralized in one individual, the CEO. This is very typical of Chinese private enterprises with a majority owner. In four of the five cases, the CEOs or their immediate families owned 100% of the company shares, and in the fifth case the CEO directly and indirectly owned a majority of the shares (51%). We visited

the five manufacturing firms twice, once in September 2006 and later in June 2007. In May 2008 we sent a questionnaire to the companies requesting additional data and a number of clarifications. We then conducted in-depth telephone interviews with the CEOs in November 2008, just two months after the global financial crisis had reared its head with the collapse of Lehman Brothers. We concluded the data collection in March 2013 by conducting detailed phone interviews with the companies. We spread our data collection over five distinct points in time since these moments gave us very different observation points within the fast changing backdrop of the Chinese economy: September 2006 corresponds to the end of the ideal period of high growth and low inflation; June 2007 saw the accentuation of different macroeconomic problems in China (explained in detail later); November 2008 witnessed a China struggling with the worldwide financial crisis; while March 2013 saw a once-in-a-decade leadership transition. Descriptive data of the five firms are provided in Table 2 (the names of the firms have been disguised to protect their confidentiality).

Insert Table 2 about here

During the first visit, data were collected through interviews, production site visits, and requests for documentation. Three researchers were present during both visits, two of whom are native Chinese and also speak fluent English. The interviews were all conducted in Chinese and English. The interviews in the first visit were not taped, to put the subjects at ease about the research (Chinese firms were not yet accustomed to openly

sharing their information with researchers). Detailed notes were taken by all three researchers and compared to ensure that they had obtained a consistent understanding of the issues from the visits. The interviews were semi-structured, and in all cases followed a round table format in which the CEOs and their management teams were present. We were mainly interested in information provided by the CEOs, since we knew that all the key strategic and operational decisions were made by them; the management teams were present only to provide back-up information to inputs provided by the CEOs. The interviews lasted three to four hours for each company. Supplementary data, such as organizational charts and financial statements, were provided by the companies. The second and third rounds of interviews (June 2007 and November 2008) were all taped, transcribed and translated into English. After a fourth researcher (who had not been on the company visits) studied the data of the first two rounds of interviews, a questionnaire was sent to the companies in May 2008 to obtain additional information. A final round of interviews was conducted and via phone in March 2013 to obtain an update on the companies and to document further changes in strategic direction, if any, in the context of the global financial crisis over the previous four and a half years and the just concluded leadership transition in China.

For our data analysis, two co-authors coded the responses (with high inter-rater validity) with respect to the strategic behaviors, and the reasons for the choice of strategies. We detected stark differences in firm behaviors between period 1 (2000-2004) and periods 2 and 3 (2005-2007 and 2008-2012). We then linked the patterns of behavior to the institutional environment and to organizational filters.

Findings

Our main focus was on the 2000 to 2007 period. We did additional data collection in 2013 (for the 2008-2012 period) as a robustness check, to ensure that what we found in 2007 continued to be valid until 2012. We have chosen to divide the 2000 to 2007 period into two phases, 2000-2004 and 2005-2007. We admit that our cut-off point between the first and second phases is to some extent arbitrary, as the marketization of the hitherto planned institutional environment is a complex and continuous process that does not lend itself to clean cutoff points.

First phase 2000-2004: Intermediate stage of the transition process, heterogeneity of strategic behaviors

A first phase between 2000 and 2004 saw new entry initiatives by four out of the five firms we studied (Sporti, Wheeli, Cleani and Metali), with the fifth firm (Stepi) committing itself to competing better in its existing product category and market (see second columns of Tables 3 and 4 for new entry decisions of four firms). During this phase, China's marketization continued with its entry into the World Trade Organization and with Chinese entrepreneurs being allowed to join the Communist Party (both in December 2001, see Table 1). GDP growth continued to be high and the currency stable based on a fixed exchange rate of 8.28 CNY to the US\$. Throughout this period, labor and raw material costs were increasing steadily. The microeconomic realities of the firms, reflected in their respective industry contexts, started to become tougher, due to high rates of firm entry.

The 2000-2004 period is characterized by three different kinds of firm behavior: 1) market-related entry, i.e., into new products for existing customers (Sporti, Cleani, and

Wheeli, see Table 3); 2) unrelated entry, i.e., new products introduced for new markets (Wheeli and Metali, see Table 4); and 3) focus on competing better in existing businesses (Stepi). As can be seen from the quotes in the last columns, the reasons given for the diversification are mainly related to the focal firms themselves.

In particular, satisfaction with competitive position and with the performance of existing businesses was the key determinant in explaining whether the firms diversified or not, and the nature of such diversification.

Related diversification: Three firms, Sporti, Cleani, and Wheeli, moved into market adjacencies (related diversification). All three saw their positions being strong relative to the competition. Sporti, after 12 years of supplying miniature ball bearings to a leading US gym equipment company, started producing more and more of the gym equipment in China (motors, rollers, roller belts, structural components, treadmills and finally motorized sofas). Cleani sought to expand its offering to its existing customers and become a “one-stop shop” for electro-static discharge (ESD) products used in the electronics and pharmaceutical industries. Thus it introduced ESD shoes in 2000, cleaning services in 2001, anti-static wipes in 2001 and anti-static mats in 2002. Wheeli, which had been supplying synthetic diamonds used for cutting blades to distributors outside China, started producing cutting machines, which use the blades. In all three cases, the companies leveraged their understanding of the market (customers) to enter into adjacent areas. We identified market linkage as the key in these largely successful new entry initiatives.

Insert Table 3 about here

Unrelated diversification: Metali and Wheeli branched out in this period into unrelated areas.

Insert Table 4 about here

Wheeli entered the business of aluminum wheels for automobiles in 2004, mainly due to lack of growth opportunities in cutting blades and cutting machines, and availability of slack resources (land). According to the Metali CEO, the gross margin in the steel bars business in 2001 was “good”, i.e., approximately 8%, but he expected many new competitors to come in due to the low entry barriers. As he had predicted, the margins dropped to between 1% and 2% by 2003. The nails and screws business (standardized parts) turned out to be more difficult than the CEO had anticipated; they had expected to make gross margins in the range of 20-30%, but the actual margins were far lower, between 5% and 10%. The business was profitable only when capacity utilization was high, and the retention of skilled workers was a challenge.

Metali made a second entry into a new business (industrial gear manufacturing and the ancillary business of heat treatment for metals) at the end of 2002. Over time, one of their main markets for gears was wind turbine producers. The CEO explained the decision to enter into this new business as the result of dissatisfaction with the

profitability of their existing businesses (reinforcing steel bars, nails and screws). *Strategic focus:* One firm, Step1, remained in the same business, metal and wooden stairs for upmarket homes, from the time it was constituted in 2001 to the end of phase one in 2004. The CEO shared the following example with us to illustrate the fierce price competition in his business: in 2002, they sold a particular model of imported stairs for 25,000 to 30,000 CNY. The same model was produced in China and was sold in 2003 for 19,800 CNY. The reduction was mainly due to increased price competition between a much larger number of competitors. In spite of this sharp fall in prices, the CEO of Step1 believed that the company enjoyed a very high gross margin (30%) on its sales.

Second phase 2005-2007: marketized institutional environment; homogeneous firm behaviors

By the start of this second phase, all five firms had buckled down to fine tune their existing businesses and focus on improving their competitiveness. During this period, the important property law protecting the assets of individuals came into effect (2007) and a new labor law was passed, which would take effect from 1 January 2008, resulting in higher labor costs for firms. While GDP growth continued to be strong, the RMB appreciated 18%, making exports less competitive. The Chinese government also withdrew export subsidies (mainly in the form of VAT rebates) for low value added products. Labor, raw material, energy and transportation, and environmental compliance costs rose sharply, and the microeconomic conditions became much tougher due to heightened competitive intensity. The strategic focus and the priorities of all five firms are described in Table 5. The worsening of environmental conditions is captured through interviewee quotes in Table 6.

Stepi: Competition had intensified; the price of the stair model that in 2003 had sold for 19,800 CNY had fallen to 12,000 CNY in 2006. There was one competitor, referred to by the CEO of Step i as “the crazy guy”, who seemed determined to drive prices even lower. Nearly a third of the 27 pages of the second round interview transcript were dedicated to this competitor. In response, Step i’s founder and his team remained focused on innovation, which resulted in new designs being launched regularly.

Wheeli: This company in 2007 saw 20% of its turnover coming from its original synthetic diamond business and 10-20% coming from its cutting machines business (launched in 2001), which though highly profitable had a business volume that was considerably below production capacity. The remainder came from the aluminum wheels business (launched in 2004), which was losing money due to increased competition. The CEO estimated that there were 180 producers of automotive wheels in China, of which 60-70 had entered the business in 2006. Wheeli estimated it ranked 80th in the industry according to revenues.

Sporti: The CEO of Sporti also mentioned very difficult macro and micro-economic conditions - he was particularly affected by the appreciating CNY and rising gasoline prices (which had an impact on plastics). He was broadly satisfied with the profitability of the business and was convinced that focus was essential to long-term success.

Cleani: The CEO of Cleani opined that although pressure on profits was increasing - he mentioned that the garments they had sold some years ago for CNY100 were now priced at CNY30 - there were some favorable developments that boded well for the industry, such as the entry of multinationals and the disappearance of many smaller competitors (although he complained that this process of consolidation was too slow). He

believed that the multinationals would educate the customers about quality and product features and this would benefit the better local companies such as Cleani.

Metali: This company, which had launched its gear business in 2003, was benefiting from two advantages: 1) it produced a high value added, capital intensive product and was thus less affected by rising labor costs and the withdrawal of subsidies for exports; 2) it sold its gears to the wind energy equipment manufacturers, whose business was booming as a result of the Chinese government's emphasis on clean energy. The company was, however, suffering from rising energy costs (which accounted for as much as 60% of the processing costs of its heat treatment business) and rising raw material costs.

Insert Tables 5 and 6 about here

In this phase, all five companies put a stop to new entry initiatives and introduced several measures to improve their competitiveness. See Table 5 for a detailed description of the five firms' priorities during the 2005-2007 period, with representative quotes.

Third phase 2008-2012: marketized institutional environment; continuation of homogeneous firm behaviors

The third phase was critical to our longitudinal study because we were able to check whether the behaviors we had observed during the 2005-2007 phase continued during and after the worst global recession in several decades.

During this third phase, we saw a continuation in the behaviors observed in the second phase in that none of the firms practiced unrelated diversification. Thus, the

strategic focus behaviors were followed for eight years (2005-2012) over changing economic scenarios, and improved the robustness of our finding in the second phase (2005-2007) of the shift in behaviors.

In the 2008-2012 period, our subject firms experienced improvements on two fronts: first, although fierce competition continued to be an issue, none of them complained of new entrants, and two actually stated that there were fewer competitors in 2012. Second, raw materials costs either remained stable or decreased.

They also experienced deterioration in the external environment in two other key respects: first, labor costs rose by between 50% and 100% between 2009 and 2012, and second, the behaviors of governments (central and local) were perceived as being selective and lacking in fairness by the subject companies (for example, in the collection of taxes).

Discussion and Conclusions

Unless most previous studies on institutional change that have looked at field level changes, ours has focused on major macro-level changes, in particular those that involve gradual transitions from planned to market economy economies. We propose that the dispersion of firm behaviors (related entry, unrelated entry and focus on existing business) observed during the intermediate stages of the transitions is due to the equivocal nature of the institutional environments (resulting from a high degree of institutional complexity), moving as they in a gradual fashion from planned to market economies. On the one hand, they still possess many characteristics of planned systems that lead firms to diversify, whether as a hedge against uncertainty (Guthrie, 1997) or to exploit opportunities by filling institutional voids (Khanna and Palepu, 2000; Leff, 1976,

1978). On the other hand, they begin to manifest some of the characteristics of market economies, especially the higher rates of firm entry leading to an intensification of competition. The institutional signals can therefore be interpreted in different ways by firms, and we argue that in such equivocal situations, organizational filters play an important role in determining how firms make sense of the signals. This results in the strategic behavior of companies being more contingent and less predictable than in unequivocal environments.

As the institutional environment becomes more and more marketized, the institutional signals become more and more unequivocal (resulting from lower institutional complexity), which means that the key feature of market economies - the need to compete based on deep knowledge and capabilities in specific businesses - starts becoming obvious, as does the reality that the grass is not necessarily greener in other industries. This greater level of marketization is reflected in a deterioration of field level conditions – higher competition leading to downward pressure on prices and margins, shortage of labor supply leading to high wage costs and higher attrition, higher raw material costs (because the process of marketization is typically accompanied by economic growth, which increases the demand, relative to supply, for factors of production), and lower subsidies. Organizational characteristics become relatively less salient in the framing of the firms' responses, a finding consistent with Tolbert and Zucker (1983) and Baron et al. (1986). During this period, companies take decisions and actions more as a function of the institutional environment and field level characteristics than of the organizational characteristics (as can be seen from the interview quotes in Tables 5 and 6).

Our key contributions are rooted in the hybrid period of institutional transition, roughly midway from a planned to a marketized institutional environment. Specifically, we propose i) greater heterogeneity of firms behaviors during this hybrid period, where institutional complexity is at its highest due to the lack of a clearly dominant institutional logic, and ii) a much more important role for organizational filters in how decision makers make sense of the institutional environment. Our findings also suggest an additional item, perceived firm performance, to the organizational filters listed by Greenwood et al. (2011). In contrast, in advanced stages of marketization, institutional signals become unequivocal and are interpreted more uniformly by organizations. The importance of organizational filters in these later changes diminishes relative to the intermediate stages of transition. Organizational strategies focus more on competitive resources and capabilities emphasized in traditional strategy research (e.g., innovation, quality, financing, and marketing), which are independent of the firm's networks, relationships, and connections (Barney, 1991). At the field level, the high rates of firm entry that are characteristic of the early stages of marketization start to moderate as marketization progresses.

Peng (2003) affirmed that “while it is possible that different strategies may be useful during different phases of the transitions, the mechanisms of such a shift still remain to be explored” (p. 283). Our findings allow us to present a much more nuanced picture of the some of the contextual mechanisms that might drive firm-environment co-evolution. Our review of the institutional changes in China during the past thirty years shows a clear trend towards a better institutional environment for private firms. This developmental trend mitigates the threat of state expropriation of their property and offers a more stable

and secure environment, which in turn leads to private firms incorporating long-term strategic behaviors, such as greater commitment to specific industries and businesses, manifested in a willingness to make large-scale investments and work towards the development of capabilities.

However, our study also contributes the insight that while the macro-environment (the institutional context) typically becomes more secure for private firms as a whole due to the transition from a planned to a market economy, the micro-environment (the industry context) initially reflects heightened competitive intensity (due to massive rates of new firm entry) leading to a relative weakening in bargaining power with customers and other factor suppliers (especially labor).

As noted by Peng (2003, pp. 275), the organization and strategy field's tendency to resist engagement with major transitions taking place in emerging economies may keep the field "on the sidelines in debates about issues in which it potentially has much to contribute (Pfeffer, 1997, pp. 24)". This study helps correct the parochial tendency that Pfeffer (1997) cautioned against.

Our study suggests two implications for SMEs in transitional economies: i) their strategy has to shift towards the development of capabilities (Peng, 2003) and ii) new entry that is driven mainly by dissatisfaction with the growth prospects and perceived performance of existing businesses (i.e., "the grass is greener on the other side of the fence" phenomenon) can turn out to be illusory. On the other hand, venturing as a means of strengthening the competitive position in existing businesses can be a sound strategic move.

As far as future research avenues are concerned, it is clear that our subject companies, which just like most Chinese companies in the early stages of economic reform had relied on low costs for their survival and success, were struggling with rising costs on a number of different fronts. Companies from other economies such as Korea and Japan have made a successful transition from costs to efficiency and finally to innovation as the drivers of their success. Scholars could document how this transition was achieved, with a view to helping companies facing similar challenges.

We are also cognizant of the limitations of our study. First, the difficulties of extrapolation are obvious with our convenience sample of only five firms. For this reason, we do not present our study as a test of existing theory; rather, we see it as providing rich descriptive and explanatory detail for a theory at the early stages of its development. Second, research in the social sciences has been characterized by the difficulty of drawing clean causal linkages between macro-phenomena and the behavior of micro-agents. While we have attempted to outline these linkages, we are aware that they are not as “clean” as we would like them to be. These shortcomings hopefully do not detract from the contributions of this study.

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Table 1: Institutional Changes in China

Fields	Institutional Change	Year	Impact on Chinese economy
Political and institutional recognition of private firms in China	Provisional Regulations of the People's Republic of China on Private Enterprises	1988	Private firms acquire legal status; have more protections from governments and support from public. Between 1988 to 1992, many private enterprises registered as collective enterprises ("red hats") to achieve legitimacy; between 1992-1997, 90% of collective enterprises revealed true identity (He, 2009)
	Establishment of socialist market economy as the goal of economic reform	1992	Economic development becomes priority of governments at all levels. <i>The goal of economic reform is to establish a socialist market economy</i> —Report to 14 th National Congress of the CPC, Jiang Zemin
	Entrepreneurs allowed to join the Communist Party. Three Representatives theory of Jiang Zemin is added into party constitution.	2001-2002	More private firms. Private firms gain political influence.
	Property law	2007	More incentives for private firms
Market condition in China	Reform of export subsidy policy	1998-2007	Less profit for manufacturing firms
	Entry into WTO	2001	Introduction of market institutions, close connections between Chinese economy and international economic trends
	Reform of exchange rate system	2005	Gross margins of export firms shrink, and more firms choose to invest abroad
Labor supply in China	One-child Policy	1980-2007	Decreased labor supply begins in 2000, increased labor costs; young workers demand more salary than their elders, and more welfare, such as sports facilities, holidays.
	Labor law	2007	Increased labor costs, less profits for labor intensive industries
	Entrepreneurship gradually legitimated in society	1980-2010	More private firms (between 1990 and 2004, number of private firms increased 37 times; number of private investors 43 times (He, 2009)); private sector entrepreneurs projected as role models for youngsters
Social recognition of private firms in China	The idea of making money gradually legitimated by the public. <i>To get rich is glorious</i> – attributed to Deng Xiaoping	1980-2010	More and more people aspire to start their own ventures
Market condition in China	The value of environmental protection widely recognized and legislation introduced	2000-2010	Manufacturing firms need to spend more on waste treatment
	Chinese entrepreneurs rapidly imitate others	1982-2010	The economic fluctuation is greater
Labor supply in China	Young workers gradually become aware of and demand more welfare and rights	2000-2010	The proportion of labor income in the economic distribution is larger than before.

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Table 2: Descriptive Data of Five Companies

	Cleani	Stepi	Metali	Wheeli	Sporti
Year founded	1997	2001	1998	1982	1994
Principal products	Products for the clean rooms of the electronic and pharmaceutical industries: 1. Clothing, boots, gloves 2. Cloths 3. Sticky mats 4. Ionizing ventilators	Wooden and metal staircases for private houses.	1. Metallic bars for building 2. Small standard metal parts (bolts, nails, screws) 3. Heat treatment for internal requirements or external customers 4. Machining of gears	1. Cutting blades 2. Cutting machines 3. Aluminium car wheels	Started selling ball bearings, then electric motors. Now sells finished products (fitness and body-building equipment, sofas, etc) to US gym equipment and furniture brands (who supply retailers such as Wal-Mart)
Ownership	100% owned by the General Manager	Owned 30% by CEO, 30% by managers and 40% by parent company, itself owned 51% by CEO and 49% by a state-owned enterprise	100% owned by the General Manager	100% owned by the General Manager's family	100% owned by the General Manager
Sales (in millions of yuan)					
	70	17.9	242	13.87	252
	100	19.4	228	97.19	320
Profit (in millions of yuan)					
	7	0.34	8.8	-2	33
	8	1.27	4.5	6.23	46
Workforce					
	440	160	93	200	110
	606	150	121	259	130
% of export sales	21% directly, large amount of indirect exports	Exports begun to Kazakhstan	Indirect exports (standard parts and gears)	95%	100%

Table 3: Salience of Organizational Filters - Related New Entry (2000-2004)

Firm	New Entry Decisions	Representative quote
Iteani (original product Electro-Static Discharge (ESD) costumes and gloves for electronic and pharmaceutical industries)	<ul style="list-style-type: none"> - Electro-Static Discharge (ESD) shoes - Cleaning services - ESD wipes - ESD mats 	<p>“We considered, at that time, setting up a portfolio to supply the electronics plants, because we already had anti-static costumes and gloves. We realized we could strengthen our competitiveness if we satisfied the need. We considered increasing our competitiveness through providing a whole portfolio.”</p>
Sporti (original product bearings for US gym equipment manufacturers)	<ul style="list-style-type: none"> - Motors for gym equipment - Rollers for gym equipment - Roller belts for gym equipment - Structural components for gym equipment 	<p>“For 12 years since its establishment, (Sporti) has been in close cooperation with one of the largest gymnastic equipment manufacturers in the US, and has finally become an OEM supplier. (Sporti) has received much technical assistance in the development of new products. As our customers had confidence in us, our business had been growing all the time.”</p>
Wheeli (original product synthetic diamonds used as cutting blades, supplied to distributors of cutting machines)	<ul style="list-style-type: none"> - Cutting machines in 2001 	<p>“The main reason lay in the fact that the competition in the cutting blades business was very intense and there was no big differentiation between products. Our cutting blades, which are installed on the cutting machines, were regarded as a derivative. We saw the cutting machine market and the cutting blade market share many things in common. What’s more, very few domestic companies made small specialized cutting machines at that time.”</p>

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Table 4: Salience of Organizational Filters - Unrelated New Entry (2000-2004)

Firm	New Entry Decisions	Representative quote
Heeli (original product synthetic diamonds used as cutting blades, supplied to distributors of cutting machines; cutting machines were added in 2001)	- Aluminum wheels for automobiles in 2004	“Without scale economy, the business could not grow big. Secondly, the land where we produce wheel hubs now was bought in 2003, and we intended to make full use of that piece of land. The automotive industry was a good choice at that time”
Metal (original products reinforced steel bars for construction)	- Manufacture of standardized metal products such as nails and screws in 2001 - Manufacture of industrial gears (such as for wind turbines) in 2002	“There were 2 factors. Firstly, steel bars have very little technological content, ...; secondly, I perceived, at that time, there couldn't be a sustained demand for steel. But in retrospect, the market wasn't that bad. ... Our original products (steel bars) required simple processing. But nails are standardized products that require a variety of processing procedures. ... We had some personnel and facility foundation, and therefore it felt easy to expand our business” “Having been engaged in the manufacturing of standardized items, we found the management rather complicated and profit could only be achieved when capacity utilization was high. Moreover, technical workers, who played a main role in the manufacturing of standardized items, were not stable. We were looking for something better. Then we found firstly, that the gear business was in the process of upgrading and generation, and secondly, it required certain technological threshold, thus presenting certain obstacles for entrants.”

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Table 5: Salience of Institutional Pressures - Strategic Focus to Improve Competitive Position (2005-2007)

	Priorities	Representative quotes
irm epi	<ul style="list-style-type: none"> - Innovation (New Products) - Gaining advantage over one aggressive competitor - Compete with companies using lower grade material - Managing staff costs and retention 	<p>“I pay 80,000 to 100,000 (CNY) a year for a group leader of painting, an ordinary painting worker 1,000 to 2,000 (CNY) a month.I had 8 workers stolen by other companies recently.”</p> <p>“Especially in the late half of this year (2007), we have been involved in a price war.... During the exhibition, many competitors issued their challenges and made their lowest price public. It was a very Chinese way of doing business”</p>
Wheeli	<ul style="list-style-type: none"> - Surviving competition in aluminum wheels (60-70 new producers entered market in 2006) - Resisting customer pressure for price reductions 	<p>“The competition has increased. Reducing prices for sure affects us greatly, also the cost, exchange rates.”</p> <p>“Customers ... will not ask for reducing the price rashly But after some time, they will ask to reduce the price again, saying that they visited other factories and knew their prices.”</p> <p>“There will still be market space for wheels in the next 5 years. But there must be many enterprises, ... even losing money and finally going bankrupt. . We are now thinking about how to survive. If we improve our internal management, it is very possible to have 8% to 10% profit every year.”</p>
Sporti	<ul style="list-style-type: none"> - Overcoming effects of CNY appreciation - Surviving increases in raw material costs 	<p>“Since September last year, the change of exchange rates is about 3%. But the adjustment in customers’ orders cannot reflect this change at all”</p> <p>“Generally speaking, the business environment has become harder.”</p>

Cleani	<ul style="list-style-type: none"> - Consolidate strong market position - Prepare to satisfy more demanding customers 	<p>“Firstly, some small companies cannot survive in the market and this business is becoming more and more concentrated. Secondly, though not many, the world’s top 500 companies begin to enter this industry, like Kimberly (Clark). ... we take the severe competition positively because it helps to regulate the industry.”</p>
etali	<ul style="list-style-type: none"> - Prepare to meet explosive market growth (expected to grow 10 times over next 3 years) resulting from favorable government policy - Weather impact of high energy costs 	<p>“The business environment of bars is getting worse. The demand in the domestic market is shrinking.... and the gross margin is only a little more than 1%.”</p> <p>“Chinese government ... fixed objectives for main Chinese electricity producers to increase 10 times the proportion of electricity production from wind from now to 2010. We produce gears ... as substitutes of imported products. There are only 4 or 5 enterprises of large scale in this industry.”</p> <p>“Before 2005, it seemed that every industry was profitable because there were many opportunities in the market. After 2005, ... you can’t survive with a wide business range. Only specialization can keep you alive. So we shrink our business range and concentrate on one business.”</p>

Table 6: Salience of Institutional Pressures - Deepening Commitment to Existing Businesses (2008-2012)

Firm	Key issues faced	Representative quote
Irm Ieani Electro-Static Discharge (ESD) shoes Cleaning services ESD wipes ESD mats	<ul style="list-style-type: none"> - Competition for talent from large state-owned banks, power and telecommunications companies - Rising labor costs 	<p>“More than a decade ago, luck mattered most. One good opportunity would make it possible for you to make a fortune within a few years. Small companies will likely collapse within five years. Owing to cut-throat competition and higher threshold for market entry, you will see few opportunities for getting rich through trading or social connections.”</p>
Theeli - Cutting blades - Cutting machines - Aluminium wheels	<ul style="list-style-type: none"> - Unstable governmental policies; preferential treatment received by some companies - Rising labor costs 	<p>“Different from low management level prevalent in the industry we have (now) adopted good management.... We have implemented a budgeting system for each workshop..... Therefore, everyone has good cost-consciousness. In the past, as long as you worked diligently to catch good opportunities, you were more likely to succeed. 30 years ago, there was not much requirement, no strong competitor and limited barriers to entry; in contrast, there are many powerful competitors now.”</p>
Metali	<ul style="list-style-type: none"> - Rising labor costs - Selective enforcement of regulations 	<p>“The wind energy business was thriving in 2009 and 2010, but it shrank dramatically during the second half of 2011. Gear manufacturers also face an overcapacity problem. ... we are more focused on our main businesses and strive to improve our operational capabilities in terms of technology, process and cost. As there were more opportunities in the initial stage, entrepreneurs were more adventurous in trying out new opportunities. Now they have to meet many conditions to seize these opportunities.”</p>
Stepi	<ul style="list-style-type: none"> - Rising labor costs 	<p>“We plan to set up independent departments with their own profit and loss targets, but it will take a long time to accomplish this. It has become a clear trend that the market is more professionalized. Meanwhile, we are facing fierce competition from many local factories.”</p>

Table 7 - SME Leaders' Assessment of External Environment in 2008 (Quotes from interviews conducted in May 2008)

Stepi	Good treatment such as higher salary is a must to all workers instead of some important workers. Now, workers know well about the labor law, some workers even ask advice from lawyer. It has not happened in a few years ago, and overtime was normal at that time. Personnel cost increased a lot in the past a few years. Mechanization, outsourcing will be the way to decrease the personnel cost. Today, it is not easy to keep employees. Performance assessment is helpful to inspire the key staffs. The main impact of exchange rate increase is on the cost of raw materials, while currently it is not a big impact to the total cost. (Subsidies) can be ignored. The price of raw material increased fast and out of control.
Sporti	The workers know the labor law quite well, and the payment increased a lot. (Personnel cost is) about 10% of the selling expense; risen a lot versus 10 years ago, and raised total cost. (Employee turnover is) 15% on average. Our products are sold in the export market, the rising currency cut down the profit directly. China will reduce tax rebates on exports, and it will also impact our profit. (Raw material accounts for) about 50% of the total cost. The higher prices of raw materials increased the cost significantly.
Cleani	Legal awareness has been raised and channels of information have been expanded in the past a few years. Fully taking into account the welfare of workers has become the must. (Personnel cost) raised a lot versus 10 years ago, and raised total cost. (Employee turnover has) gone up a lot versus 10 years ago, personnel management became more and more important. (The rising currency) cut down profits when we export products to Southeast Asia. As a high-tech enterprise, we enjoy preferential income tax rate 15%. The higher cost (of raw material) cut down the profit.
Wheeli	Labor resources shortage, wage increase, staff mobility, higher literacy levels. (Personnel cost) keeps going up. Higher employee turnover currently. (The rising currency) cut down the profit a little bit. Currently we still enjoy the VAT (Value Added Tax) rebate. Currently, the cost (of raw materials) is really high.
Metali	Labor resources became more and more scarce, but as a non-labor-intensive enterprise, it is not a big impact to my business. Personnel cost increased significantly, fortunately it is not a big percentage of the total cost. No change (in employee turnover). Little impact (of rising currency); if we import machines in future, it can help to lower the cost. There are less preferential tax policies. (Raw materials) have increased the total cost significantly.

Note: Interviews followed a structured format. Interviewees were asked about how the following factors had changed in 2008 with respect to when they started their companies: labor supply, personnel cost, involuntary labor turnover, appreciation of Chinese currency, and subsidies for business (including tax subsidies). Other items relating to external environment were also covered, but have not been reported in the table due to space constraints, such as availability of office staff, availability of managers, environmental regulation, energy costs, transportation costs etc. The responses on these factors were consistent with those reported in this table.