5. Revisiting liability of foreignness: socio-political costs facing Chinese multinationals in the United States

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Alien status always imposes some penalty on managerial effectiveness. (Caves 1971, p. 6)

INTRODUCTION

China's gaze is now looking outward. With over $1 trillion in foreign exchange reserves at the beginning of 2008, the Chinese government encourages domestic firms to engage in a strategy of outward direct investment – "Going Global." In addition, the China Investment Corporation (CIC), the new state agency inaugurated in October 2007 with a registered capital base of $200 billion, has been set up to make its own overseas investments (*China Business* 2007). In 2006, Chinese outward foreign direct investment (FDI) flows had reached $18 billion, for a stock of $82 billion (Kekic and Sauvant 2007). Firms are expanding abroad – and one of their primary destinations (as so many firms before them) is the United States of America.

As Chinese investment into the United States increases, one cause for concern for Chinese executives is liability of foreignness (LOF), which refers to the added costs, specifically socio-political costs, faced by the foreign affiliate of a multinational enterprise (MNE) that are not incurred by domestic firms in the host country (Zaheer 1995). In this chapter, we ask what kinds of LOF costs face affiliates of these new Chinese multinationals when they come to the United States. Our study focuses on LOF costs to both Chinese parent firms and their US affiliates.

We begin by discussing liability of foreignness and focus on the key driver of the level of LOF – differences in the institutions of two countries (that is, institutional distance). We explore three types of institutions (regulatory, normative, cognitive) and argue that both the difference between, and the level of, institutions matter when a foreign firm enters a host country. We then link LOF to the institutional distance between China and the United States as we highlight the principal legal and non-legal costs that may arise after a Chinese firm establishes a US affiliate. Lastly, we outline possible strategies that Chinese MNEs can use to cope with these socio-political costs.

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5.1 LIABILITY OF FOREIGNNESS AND INSTITUTIONAL DISTANCE

5.1.1 Liability of Foreignness

The costs of doing business abroad measure all the costs faced by a home country firm associated with its activities in a foreign country, over and above the costs faced by a local firm conducting similar activities. These costs can be separated into activity-based costs and liability of foreignness (Eden and Miller 2004). Liability of foreignness manifests itself as unfamiliarity costs, discriminatory costs and relational costs.

Unfamiliarity costs reflect a foreign MNE's lack of host country knowledge compared to domestic firms in the host country. Discriminatory costs reflect the differential treatment of foreign MNEs by producers, consumers, factors and governments in the host country (Balabanis et al. 2001; Henisz and Williamson 1999; Sumner 1906), including both formal and informal discriminatory treatment.[1] Relational costs represent the additional administrative costs of managing relationships at a distance, for example between a parent firm and its foreign affiliate or between the two partners if the affiliate is constituted as a joint venture with another firm (Buckley and Casson 1998; Henisz and Williamson 1999). Relational costs include both the managerial information-processing demands of managing highly complex internationally diversified firms and the negotiating, monitoring and dispute settlement costs of dealing with foreign partners. One set of costs could influence the other; for example, discriminatory treatment by a host government might encourage a domestic licensee or joint venture partner to become more opportunistic in its dealings with a multinational, so that political discrimination encourages interorganizational relational costs (Henisz and Williamson 1999).

What causes liability of foreignness? Why do foreign firms face additional costs not faced by domestic firms in a host country? We argue that institutional distance is the cause.

Institutions

In order to understand institutional distance, we must first understand institutions. Nobel laureate Douglass North defined institutions as: "the rules of the game in a society" (1990 p. 3). Institutions can be formal constraints (for example, laws) as well as informal constraints (codes of behavior) that underlie or supplement formal rules (North 1990). These classifications coincide well with research that has emphasized regulatory, normative and cognitive pillars of institutions (Scott 1995, p. 33), in that formal constraints are shaped by regulatory institutions while informal constraints are shaped by normative and cognitive institutions.

The regulatory pillar deals with "existing laws and rules in a particular national environment which promote certain types of behaviors and restrict others" (Kostova 1997, p. 180). It outlines prescriptive ("may") and proscriptive ("may not") behaviors, and applies rewards and sanctions for compliance with these pre/proscriptions. The regulatory pillar is perhaps the easiest for foreign MNEs to observe, understand and correctly interpret because host country regulatory institutions tend to be codified and formalized in rules and procedures.

The normative pillar consists of "social norms, values, beliefs, and assumptions about human nature and human behavior that are socially shared and are carried by individuals" (Kostova 1997, p. 180). The normative pillar is "rooted in societal beliefs and norms" (Xu and Shenkar 2002, p. 610) about how things should and should not be done. Such informal prescriptions and proscriptions are often culturally driven, and therefore difficult for outsiders to see and interpret (Kostova and Zaheer 1999).

The cognitive pillar affects the "schemas, frames, and inferential sets, which people use when selecting and interpreting information" (Kostova 1997, p. 180). Cognitive institutions affect "the way people notice, characterize, and interpret stimuli from the environment" (Kostova 1999, p. 314) in terms of national symbols, stereotypes, key sectors, and so on.

In sum, as Eden and Miller (2004) concluded, the regulatory pillar defines what organizations and individuals "may or may not do" (where "may" implies permission), the normative pillar defines what they "should or should not do", and the cognitive pillar defines what "is or is not true" and what "can or cannot be done" (where "can" implies ability). Thus, the three pillars are akin to three verb tenses: may/may not (regulatory), should/should not (normative) and can/cannot (cognitive).

Institutional distance

The institutional distance between two countries is the degree of difference/similarity between the regulatory, cognitive and normative institutions of two countries (Kostova 1997). Institutional distance can be different for each of the three institutional pillars: regulatory, normative and cognitive. In all three cases, we argue that greater institutional distance increases the liability of foreignness and the need for foreign MNEs to be locally responsive to host country institutions.

Regulatory institutional distance measures the difference between home and host countries in terms of the setting, monitoring and enforcement of rules. Within developed countries, regulatory frameworks have become more homogeneous due to globalization pressures, regional integration schemes and international institutions such as the World Trade Organization and the Organisation for Economic Co-operation and Development (OECD). As a result, regulatory distance between OECD member countries has been falling for many years, and in most industries may now be considered minimal.

Even in the emerging economies of Asia, Latin America and the former USSR, the ability of governments to force unilateral policy changes on MNEs has been substantially curtailed by the web of bilateral investment and double taxation treaties, membership in international organizations, and structural adjustment constraints imposed by the World Bank and International Monetary Fund (Ramamurti 2001). In addition, almost all national policy changes affecting MNEs since the early 1990s have been liberalizing (UNCTAD 2007); as a result, the regulatory institutional distance between OECD and emerging economies has been falling. We therefore conclude that regulatory distance, for most industries and countries, is low and therefore is no longer a primary driver of LOF for MNEs entering most (but not all) industries in most (but not all) host countries.[2]

Normative institutional distance is generated by differences across countries in societal beliefs about how things should and should not be done. Because norms are typically informal and tacit, foreign firms are likely to have great difficulty understanding host country institutional guidelines, which increases the likelihood of discriminatory treatment (Kostova and Zaheer 1999). Moreover, with high levels of normative distance, it is more difficult for a parent firm to transfer organizational practices to an acquired local affiliate, especially when the practices of local firms are institutionalized in the host country environment. This difficulty in transferring practices within a MNE group raises the intra-relational costs of managing operations at a distance. Therefore, we expect unfamiliarity, discriminatory and inter- and intra-relational costs all to increase with normative distance.

Cognitive institutional distance facing the MNE is caused primarily by differences among countries in their national symbols and stereotypes. Cognitive institutions represent "the way people notice, characterize, and interpret stimuli from the environment" (Kostova 1999, p. 314). Cognitive institutions are affected by the way domestic firms and consumers interact with, and how they view, foreigners. Kostova and Zaheer (1999) suggested that foreign firms can incur stereotyping by host country institutions and organizations due to their unfamiliarity with outsiders. For example, industries with strong national symbolism (such as the petroleum industry in Mexico) typically have low penetration rates by foreign firms due to substantive host country regulations restricting foreign equity ownership. When cognitive distance is high, acquisitions are viewed as "takeovers" and a "blow to national sovereignty" from the local market's perspective (Xu and Shenkar 2002, p. 613).

Institutional levels versus institutional distance

Emerging economies in Asia and Latin America tend to have weak formal institutions and are therefore more likely to rely on informal institutional enforcement procedures such as networks, *guanxi* and family conglomerates. When an MNE moves from a country with high-quality, well-developed institutions (for example, the United States) to an emerging economy where the institutions are less developed, clearly there is institutional distance between the two countries.

In addition to the distance between the two countries, there is the issue of whether it is easier for the firm to move from low to high levels of institutions (for example, from China to the United States) or from high to low levels of institutions (vice versa). Emerging market firms that engage in foreign direct investment in a developed economy are typically moving from low- to high-level institutions, that is, from institutional voids to well-developed, market-based and more formalized institutions. We hypothesize that the costs of moving from a country with low-quality or missing institutions to a country with high-quality institutions should be larger than the reverse, in the same way that it is harder to walk upstairs than it is to walk down (the "stair-climbing" problem). Thus, the institutional distance between a developed market and an emerging economy is exacerbated when the firm involved is moving upwards in term of institutions.

Coping with liability of foreignness

We start from the premise that, holding revenues constant, the multinational enterprise wants to minimize the additional costs of doing business abroad – that is, the sum of activity-based costs, unfamiliarity costs, discriminatory costs, and intra- and interrelational costs. The greater the institutional distance, the greater the liability of foreignness faced by a foreign MNE in a host country. In order to be successful in the host country, the MNE must engage in activities (that is, select one or more strategies) to minimize or offset these LOF costs.[3]

The typical strategies for coping with liability of foreignness are designed to offset the three types of institutional distance: regulatory, normative and cognitive. As we have explained above, differences in regulatory institutions are easier for an MNE to understand since regulatory institutions tend to be more formalized in rules and procedures. In addition, differences in regulations affecting FDI flows and foreign ownership between countries have been falling for several years (with some exceptions, notably Venezuela). On the other hand, normative and cognitive institutions are more problematic since they tend to be tacit and opaque. A common strategy for coping with liability of foreignness is to take on a foreign partner ("put a local face" on the MNE in the host country), as explored in Eden and Miller (2004).

Let us now apply our LOF institutional distance framework to the case of Chinese multinationals entering the United States.

5.2 CHINESE MULTINATIONALS: SAME OR DIFFERENT?

Are US affiliates of Chinese firms different from US affiliates of other emerging-market firms or from non-US affiliates of Chinese firms? We argue that there are some key differences.

First, Chinese multinationals are latecomer MNEs, recent entrants to the world of outward FDI flows. Starting from almost zero in 1980, Chinese outward FDI flows have grown to more than $16 billion in 2006. While an impressive growth rate, China's FDI stock represented less than 0.6 percent of the 2005 world FDI stock (Morck et al. 2008). Latecomer status is likely to have both benefits and costs for Chinese MNEs. There is the opportunity to learn (the demonstration effect) from first- and second-mover foreign MNEs that entered a host country market earlier than Chinese firms, thus helping them to avoid mistakes in location choice, mode of entry and so on. As a result, liability of foreignness arising from unfamiliarity costs may be smaller for latecomers. Prior entrants may also help reduce discriminatory LOF for latecomer entrants if stereotyping and "fear of the foreigner" hazards have been overcome by prior entrants. However, competition in the host country should be harsher and the barrier to success higher due to the larger number of foreign-based competitors.

Second, multinationals in China that locate their investments in developed market economies face the "stair-climbing" problem we identified earlier. Moving from a country with weak institutions, particularly regulatory institutions, to OECD countries such as the United States with much stronger regulatory institutions, imposes unique LOF costs in addition to their latecomer status.

Third, historically, foreign investments by state-controlled firms have generally been treated with extra suspicion by local residents due to concerns about extraterritoriality (Vernon 1971; Marchick 2007). In China, as in many transition economies, many if not most of the largest multinationals are state-controlled. Moreover, many publicly traded Chinese firms have a high degree of state ownership (Miller et al. 2008). As a result, traditional concerns about loss of sovereignty, Trojan horses and so on accompany FDI by state-controlled MNEs. These concerns may have grown more pronounced as the number of state-controlled firms coming from emerging economies in Asia, Latin America and the former Soviet Union has surged and these firms have begun to invest in OECD countries (Vernon 1998).

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Lastly, investment pools funded by foreign governments, sovereign wealth funds, are now making substantive passive investments in US firms without any large public outcry (Davis and Berman 2008). Chinese foreign investments are supported by a large investment pool, the China Investment Corporation, created by the Chinese government in 2007. The fund has designated one-third of its $200 billion reserves for overseas investments (Weisman 2008). Unlike US affiliates of other emerging-market firms, Chinese enterprises now have substantial financial resources to make inroads into the US economy. This could and has created public concerns over foreign takeovers of US assets. In response, Lou Jiwei, chairperson of the China Investment Corporation, recently promised US government officials that: "China had no intention of gaining controlling interest in any companies, and that it would be a 'good corporate citizen' and not invest in companies that damage the environment, waste energy or produce tobacco" (Weisman 2008).

5.3 CHINESE MULTINATIONALS AND US REGULATORY INSTITUTIONS

As we have argued above, Chinese multinationals entering the United States face two types of regulatory barriers: the institutional distance between US and Chinese regulations, and the difference in the levels of institutions between the two countries. Chinese firms come from a much weaker home base, one that is both emerging (poor, dynamic, fast-growing) and in transition (a mixture of communist, socialist and market institutions). Thus, the regulatory distance between China and the United States is higher than for most foreign firms entering the United States, and liability of foreignness should therefore be higher.

In this section, we discuss several laws and regulations and their implications for the US affiliates and their Chinese parent headquarters – violations of which would hold the US affiliates accountable, and violations of which would hold the parent firms and their employers accountable. These regulations apply to both domestic (US) firms and foreign firms in the United States. A comprehensive analysis of every law is not feasible in this chapter. Instead, we discuss regulations that may affect both the US affiliate of a Chinese organization and its parent (the Foreign Corrupt Practices and the Sarbanes–Oxley Acts) and then highlight other regulations with implications for the US affiliate of the Chinese organization.[4]

5.3.1 Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA) is a law, passed by Congress in 1977, intended to punish and eliminate bribes paid by US firms to influence the acts and/or decisions of foreign officials (15 U.S.C. §§ 78dd-1, et seq.). The FCPA was amended in 1988 and again in 1998. The 1998 amendment sought to: (1) strike a balance between combating illicit practices while facilitating the international competitiveness of US firms; and (2) provide more extensive reach in terms of those accountable under the Act to include foreign nationals and corporations. The FCPA's anti-bribery clause applies to issuers, domestic concerns and other persons. Domestic concerns are defined as:

any individual, who is a citizen, natural or resident of the US and any corporation, partnership association joint-stock company, business trust, unincorporated organization, or sole proprietorship which has as its principal place of business in the US, or which is organized under the laws of a state of the United States, or a territory, possession, or commonwealth of the United States. (15 U.S.C.A. 78dd-2(h))

The amended FCPA, therefore, applies to officers, directors, employees, or agents of an issuer (that is, a firm that lists its stock on a US stock exchange) or domestic concern.

As a result of the above definitions, a Chinese firm that lists its stock on a US exchange must comply with FCPA and Sarbanes–Oxley (described below) as well as with the Security Exchange Commission's disclosure requirements. In this case, the parent firm can be held accountable for violations of the FCPA, even if the US affiliate was uninvolved. For example, SEC officials and the Department of Justice announced that Statoil, Norway's largest oil company, would pay $21 million, as part of its penalty for FCPA violations; however, Statoil agreed to settle for $10.5 million (Taub 2006). The Securities and Exchange Commission and Department of Justice have jurisdiction over Statoil's conduct because the company's securities – American Depository Receipts (ADRs) – are traded on the New York Stock Exchange. For an ADR-issuing firm, the applicability of FCPA to the parent firm is straightforward, regardless of whether the Chinese firm has a US affiliate. In sum, the FCPA applies to Chinese firms that issue securities and thus cross-list on a US exchange.

For Chinese firms that are not listed on a US exchange, the applicability of the FCPA depends on a number of factors. The major issue has to do with whether the US affiliate of a Chinese firm is a "domestic concern." In this chapter, we use "affiliate" to encompass a range of organizational forms such as subsidiaries or branch offices. However, it is necessary to distinguish between these two types of affiliates to understand the conditions in which the affiliate is classified as a domestic concern.[5]

There is no federal legal requirement in most situations for a foreign investor to conduct business in the United States via a separately established subsidiary. For banks and other financial institutions, a branch is the preferred method of doing business, if permitted by the regulators, since it costs less capital to operate through a branch. For some specific industries, there is a legal requirement to operate through a subsidiary rather than a branch – for example, many states require insurance operations within their territories to use subsidiaries. The issue is generally regulated by states (not the federal government, except for some financial institutions) on an industry-by-industry basis. A separately established US subsidiary of a Chinese parent firm is clearly a "domestic concern" for FCPA purposes, as explained below.

For example, if a Chinese company establishes a US-incorporated subsidiary, then bribes to non-US officials – by that subsidiary or by an officer, director, employee or agent of that subsidiary, or by a shareholder of that subsidiary (that is, the parent) acting on behalf of that subsidiary – would trigger application of the FCPA to the person or entity making the corrupt payment. Bribes by a shareholder of that subsidiary (that is, the parent) to a non-US official, but not acting on behalf of that subsidiary, would not trigger application of the FCPA. Hence, if the parent Chinese firm bribed a foreign non-US official in a matter involving the parent firm's subsidiary in a third country but not involving its US subsidiary, the FCPA would not apply.

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incorporated subsidiary), then that branch might easily be deemed to be an "unincorporated organization," which has its principal place of business in the United States (within the meaning of the definition of "domestic concern" noted above; also see 15 U.S.C.A. § 78dd-2: Prohibited foreign trade practices by domestic concerns). Accordingly, a bribe to a non-US official paid by that branch office or by an officer, director, employee or agent of that branch office or by a shareholder of that branch office acting on behalf of that branch office could trigger application of the FCPA. Thus, it would be poor advice to a foreign investor in the United States to suggest that its conduct within the United States could fall outside the FCPA just by using a branch rather than formally incorporating a subsidiary.

Corporate directors of a subsidiary are usually at the same time officers of the parent firm. If a director of a domestic concern is involved in bribery covered by the FCPA, then there is a high likelihood that the Department of Justice could form a case against the parent firm based on conspiracy or aiding and abetting. The same point often applies to senior executives of a subsidiary, who may simultaneously hold officer positions in the subsidiary and the parent firm. The parent firm may contend that the director's or senior executive's actions were not authorized by the parent firm; however, the Department of Justice tends to resist these types of arguments.

It is also important to recall that any individual who is a citizen, national, or resident of the United States will be subject to the FCPA, regardless of the nature of legal organization or nationality of their employer or indeed their own nationality (for definitions see 15 U.S.C.A.§ 78dd-2h). That clause includes officers and employees of a Chinese enterprise in the United States, unless the individual is only an occasional visitor to the United States.[6]

Finally and importantly, the FCPA is a federal criminal statute. If a Chinese individual or company not based in the United States (for example, the Chinese parent firm or a China-based executive of the parent firm) improperly cooperates with a "domestic concern" or US person in bribing a non-US official, then that non-US individual or company (that is, the parent firm or its executive) may be separately covered by the federal criminal laws for conspiracy to violate federal law, by federal aiding and abetting laws or the Racketeer Influenced and Corrupt Organizations Act. None of those criminal statutes is limited in scope to "domestic concerns." Instead, those federal criminal statutes cover all persons and entities subject to the jurisdiction of the United States fully permitted by the due process clause of the US Constitution.

5.3.2 Sarbanes–Oxley Act

In 2002, the Sarbanes–Oxley Act (SOX) came into effect and brought with it substantial changes to regulation of corporate governance and financial practices (Pub. L. No. 107-204, 116 Stat. 745). The parent firms and US affiliates of cross-listed firms are required to comply with the Sarbanes–Oxley Act. As part of Sarbanes–Oxley, executives of US listed firms must attest via signature that they have reviewed the financial statements. Moreover, they must attest to the accuracy of the financial statements. Sarbanes–Oxley penalizes executives of these firms that incur accounting improprieties.

Although only firms publicly traded on US exchanges must comply with these rigorous accounting standards, Chinese firms that cross-list via American Depository Receipts incur extremely high costs of compliance because the integrity of Chinese financial statements is subject to debate. Ambiguous accounting practices and poor enforcement have resulted in unreliable financial statements. As such, parent firms of Chinese firms that cross-list (including Chinese-owned firms in the United States that issue equity in the United States) must incur disclosure costs (that is, providing additional financial information) and potential penalties (i.e., exposing executives to the consequences of SOX violations).

5.3.3 Transfer Pricing Regulations

An important issue for MNEs is transfer pricing, particularly the tax aspects under Section 482 of the US Internal Revenue Code (Eden 1998). China's deficiency with respect to accounting standards and enforcement becomes a concern for US government officials when assessing transfer pricing of Chinese firms. Chinese firms with US affiliates may exploit transfer prices such that US taxes are avoided or underreported. US officials, aware of the less-than-transparent accounting environment in China, may be more likely to pay attention to these firms. While China has had transfer pricing regulations in place for a few years now, and these rules are based on the OECD's Transfer Pricing Guidelines (OECD 1995), the regulations in China are much weaker than those in the United States. The ability of the Chinese government to enforce these regulations is also at question since enforcement in the first place takes place at the state level with local tax inspectors. Weak administrations, corruption and lax enforcement suggest that Chinese firms in the United States must learn to deal with a much more regulated environment. Moreover, since Chinese firms are only now adopting international accounting principles, and only starting to employ the Big Four accounting firms, this is an area where the potential for disputes is high.[7]

5.3.4 Other US Regulatory Institutions

As we noted above, Chinese organizations may vary in their exposure to the FCPA and SOX. The Chinese organizations with the greatest level of exposure to US regulatory institutions – both in the United States and throughout the world – are firms listed on a US stock exchange. There are other regulations, however, that influence only the US affiliates of Chinese firms. Again, we point out that this section in not intended to be a comprehensive list. Rather, our intent is to heighten awareness of some of the more salient US regulations.

One important act is the Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act (BSA), and its implementing regulation 31 CFR 103. The US Congress enacted the BSA to prevent banks and other financial service providers from being used as intermediaries for, or to hide transfers or deposits of money derived from, criminal activity. This Act was amended to facilitate the prevention, detection and prosecution of international money laundering and financing terrorism as part of revisions to the US Patriot Act.

The Arms Export Control Act (AECA; 22 U.S.C. § 2778(a)(2)) authorizes the export and temporary import control activities of the Department of State. The AECA is the basic authority for the Directorate of Defense Trade Controls to issue regulations and administer and enforce export and temporary import controls for national security and foreign policy reasons.

The Trading with the Enemy Act (TWEA; 12 U.S.C. § 95a) restricts trade and attempts to trade:

> either directly or indirectly, with, to, or from, or for, or on account of, or on behalf of, or for the benefit of, any other person, with knowledge or reasonable cause to believe that such other person is an enemy or ally of enemy, or is conducting or taking part in such trade, directly or indirectly, for, or on account of, or on behalf of, or for the benefit of, an enemy or ally of enemy.

The International Emergency Economic Powers Act (IEEPA) grants the President emergency powers to respond to a threat to US national security, foreign policy or the economy from abroad. The IEEPA (50 U.S.C. §1701 et seq.) grants the President authority to "investigate, regulate, or prohibit" certain activities and transactions such as "the importing or exporting of currency and securities" (50 U.S.C. §1702).

The Occupational Safety and Health Act of 1970 (OSHA) is a federal statute designed to regulate employment conditions relating to occupational health and safety (29 U.S.C. 651, et seq.), which may potentially affect Chinese-owned affiliates in the United States.

During the mid-1970s the United States adopted two laws that seek to counteract the participation of US citizens in other nations' economic boycotts or embargoes. These "anti-boycott" laws are the 1977 amendments to the Export Administration Act (EAA; PL 96-72) and the Ribicoff Amendment to the 1976 Tax Reform Act (TRA; *Pub.L.* 94-455).

In sum, our overview of US regulatory institutions that could affect Chinese MNEs with operations in the United States is not exhaustive. Rather, our intent was to make salient the formal rules established by US regulatory institutions and identify some regulations that may be problematic for Chinese firms and their US affiliates. Next, we turn to the informal rules, which are captured by normative and cognitive institutions.

5.4 CHINA MULTINATIONALS AND US NORMATIVE INSTITUTIONS

Normative institutional distance arises from differences in societal beliefs about how things should and should not be done, that is, what is the best or most appropriate way to accomplish a particular task, what activities are prescribed or proscribed, what are inappropriate ways to tackle problems, and so on. Because "should/should not" norms of behavior are culturally derived and often tacit, foreign entrants (both individuals and firms) are likely to make mistakes. Therefore, unfamiliarity, discriminatory and relational components of liability of foreignness should all increase with normative distance.

Do Chinese MNEs face unique challenges in terms of normative distance when entering the US market, relative to other foreign entrants or relative to Chinese firms entering other developed market economies? We argue that the Chinese experience with US normative institutions should be similar to those of other Asian firms entering the United States. This suggests that Chinese MNEs can learn from the entry experiences of earlier

Asian entrants from Japan, the Republic of Korea, Hong Kong (China) and Taiwan Province of China into the US market.

Moreover, issues associated with normative distance are likely to occur in other societies with which China experiences substantial cultural differences. Thus, there may be nothing particularly unique about Chinese entries to the US market, in terms of normative institutions, that do not also characterize Chinese entries to other OECD markets.

5.5 CHINESE MULTINATIONALS AND US COGNITIVE INSTITUTIONS

Cognitive institutional distance is caused primarily by differences between countries in national symbols and stereotypes, the way domestic firms and consumers interact and how domestic actors (households, firms, government) view foreigners. The degree of stereotyping of foreigners depends partly on the level of ethnocentrism in the host country (Balabanis et al. 2001). Ethnocentrism reflects an unfavorable perception of outsiders and favorable perception of insiders (Sumner 1906). High levels of ethnocentrism result in stronger, more intense stereotyping against outsiders (or favoritism of insiders) and are associated with higher discriminatory LOF costs.

The size of an MNE may be important here. Firm size provides advantages such as financial strength, market power and strong reputation that should lower discriminatory costs and encourage an MNE to opt for a wholly owned subsidiary. On the other hand, as a firm's size increases, it becomes more visible in the host country. As such, there is a greater likelihood of being targeted by special interest groups, making it more difficult for the MNE to maintain external legitimacy (Kostova and Zaheer 1999).

The mix of foreign to local firms in a host country can also affect cognitive institutional distance. As Anderson and Gatignon (1986) argued, the presence of foreign MNEs encouraged local workers to "obtain a business education abroad, which in turn, can reduce problems associated with sociocultural distance and reduce the level of ethnocentrism in the host country" (Eden and Miller 2004, p. 200). As the number of foreign firms in a host country increases, the host country has more information by which to evaluate new entrants so unfamiliarity and discriminatory costs, from the host country perspective, should be lower. However, as the proportion of foreign to domestic firms rises in a politically salient industry (for example, petroleum, autos, banking), further entry can cause a backlash against foreign firms because of the perceived violation of national symbols and national security.

For many years, China has been the subject of controversy in the United States on topics such as human rights violations, insider trading (in Chinese financial markets), questionable accounting practices, intellectual property protection, international trade, undervalued exchange rates and even the loss of US manufacturing jobs (King et al. 2005; Knowledge@Wharton 2005; Marchick and Graham 2006). Exposures of tainted food products and lead paint in toys coming from China have only exacerbated these negative views of Chinese products among US consumers and firms. For example, a 2007 poll found that 52 percent of the US general public and 65 percent of US business leaders strongly agreed with the statement that: "Chinese food contamination cases have reduced your confidence in products made in China" (Committee of 100 2007). As a result, the

US public tends to regard Chinese imported products with suspicion. This stereotyping should spill over over to US affiliates of Chinese multinationals, particularly in the distribution sector where their primary function is to distribute imported Chinese goods.

For Chinese firms operating in the United States, country-of-origin effects should vary over time, reflecting swings in public opinion stemming from nationalistic views associated with US–China economic and political relations. The US–China trade imbalance, for example, which has received considerable attention from the US press, can raise tensions about Chinese imports, US manufacturing job losses to China and other controversial legal issues mentioned above. Reports that a Chinese firm engaged in bribery with a non-US official may trigger negative spillover effects to US affiliates, even though the US affiliates were uninvolved in or not found guilty of a violation. In a related example, US consumers boycotted French-made products (especially French wines) in response to the oil-for-food scandal, which implicated French, Iraqi and United Nations officials (www.boycottwatch.org; Gatti 2005).

There has been a surge in research on non-government organizations (NGOs), namely activist groups. China has been a target of criticism with respect to Tibet, human rights and child labor. The Chinese government has been able to deflect much of the criticism at home with the state-owned media and large ownership stakes in many publicly traded firms (Miller et al. 2008); however, Chinese state-ownership of a US affiliate can be a lightning rod for any country-specific or firm-specific actions perceived by NGOs.

Furthermore, NGOs receive considerable attention – whether warranted or unwarranted – from the US media, most of which are not state-owned (though a few receive some state funding). The US media, unlike its counterpart in China, can choose what information to report, how to report it, as well as what information to ignore. For Chinese firms, the NGOs, via the US media, can paint a very negative view of actions undertaken by the Chinese government, even though the actions under scrutiny have occurred outside of the United States. Such NGO actions that target the Chinese government may spill over such that US affiliates of Chinese firms serve as a focal point of the NGO allegations for US consumer and stakeholders. Therefore, the US affiliate of a Chinese firm may need to incur public relations costs on behalf of the headquarters in order to diffuse or redirect attention from home country issues.

5.6 CHINESE STRATEGIES FOR COPING WITH LIABILITY OF FOREIGNNESS

5.6.1 Strategies to Overcome Regulatory LOF

The above discussion of US regulations that affect Chinese firms and their US affiliates suggests that Chinese firms may incur additional litigation costs (in the event of violations), as well as compliance, training and recruiting costs (to reduce the likelihood of future violations). In the United States, foreign firms are sued more frequently than domestic firms (Mezias 2002) and, thus, the legal costs for representation and settlement may be substantial. Strategically, these acts may require substantial changes to an organization's value chain, resulting in higher coordination costs.

Although we expect the costs of compliance with US regulations to be higher for foreign firms, these costs may be even higher for US affiliates of Chinese firms because of China's less-than-favorable reputation regarding human rights and worker conditions. In order to overcome the home country stigma regarding employee rights and to be perceived as legitimate in the eyes of US employees and US regulators, Chinese firms will need to incur training costs to overcome unfamiliarity with US employee laws, and they are likely to endure ongoing scrutiny by OSHA officials.

Compliance training

To minimize the likelihood of violating US laws and the associated legal costs, Chinese MNEs in the United States should undergo extensive compliance training. We contend that a firm needs to view this training as an "investment" rather than an "expense," in order to underscore the seriousness of violating US laws due in part to the regulatory distance between China and the United States. As Chinese firms increase their presence on the global stage, especially in countries with stringent regulatory institutions, it is imperative for Chinese firms and their executives to improve standards not just in the United States, but also in other countries in which they operate – especially the home market. The stigma associated with Chinese firms' questionable business practices requires a proactive approach to a long-term commitment to adopting a corporate culture that encourages compliance and discourages corruption and illicit payments at home and abroad, not just a short-term public relations campaign (Bartlett et al. 2006). In doing so, Chinese firms will derive long-term benefits.

Taking on a local partner

Perhaps the most common strategy for coping with liability of foreignness is to take on a local partner – either as a joint venture or an acquisition – in the host country (Kostova and Zaheer 1999; Eden and Miller 2004). The local partner better understands the host country institutions (regulatory, normative and cognitive) and provides a "local face" for the firm in its dealings with local stakeholders.

However, a key worry for Chinese multinationals entering the United States since the 1990s has been the public outcry over Chinese full or partial acquisitions of US firms. Moreover, CFIUS can be triggered by acquisitions above a certain size or percentage of ownership.[8] As a result, Chinese firms are wary of crossing these thresholds, preferring minority stakes in US firms (Davis and Berman 2008). China's $3 billion investment in the US private equity firm Blackstone Group, for example, underscores the sensitivity of Chinese investment in the United States. China Investment Corporation requested no voting rights or influence in Blackstone's decision-making, and appears to have preempted criticism about foreign-government ownership in the event of lay-offs at any of the Blackstone acquisitions. Nevertheless, this approach seems to sidestep the LOF challenges facing Chinese organizations. Moreover, this approach presents a major obstacle to accumulating market knowledge in the United States, and thus reinforces short-term benefits with long-term costs.

In cases in which a Chinese firm does partner with a US firm, relational costs are an important consideration (Eden and Miller 2004). US firms may choose not to form alliances with firms unfamiliar with US regulations, to reduce the likelihood of legal missteps, or with firms that do not offer complementary resources. For instance, a Chinese partner's local market knowledge may be important for a US firm entering in China;

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however, this knowledge is not transferable. Further, stigmas about US jobs lost to China may produce some spillover effect as well. A US firm may not want to associate with a Chinese firm for fear of perceptions of contributing to the job loss issue. That said, intra-relational costs might arise between a US affiliate and its Chinese parent, as well as interrelational costs between the US affiliate and Chinese suppliers. These costs may stir tensions between a US affiliate and its Chinese parent, increase coordination costs and present transfer pricing issues.

5.6.2 Strategies to Overcome Normative and Cognitive LOF

How can Chinese MNEs in the United States reduce their non-regulatory (normative and cognitive) costs? An obvious strategy is to partner with local firms, which we have discussed above. We discuss alternative strategies below.

Social embeddedness: becoming an "insider"

Social embeddedness reflects the degree to which economic transactions take place through social relationships and networks of relationships that use social and non-commercial criteria to govern business dealings (Marsden 1981). A key premise of social embeddedness is the importance of "in-group" affiliations that, in turn, may lead to differential treatment and perceptions of outsiders (Tajfel and Billig 1974). Granovetter (1973) found that tight relationship ties between host country insiders led to exclusion of organizations that were unable to establish comparable ties. High embeddedness of local firms increases the distinction between insiders and outsiders that, in turn, raises cognitive institutional distance and increases discriminatory costs. Local embeddedness can also be a barrier to the sharing of information, increasing unfamiliarity costs for foreign firms. Whereas for developed market firms operating abroad, it has been hypothesized that a higher degree of social embeddedness of local firms is associated with greater cognitive institutional distance and higher LOF (Eden and Miller 2004).

Scholars have suggested that trust in cross-border business relationships is especially prevalent in Oriental cultures, which tend to exhibit high collectivism and long-term orientation that, in turn, is integrated into managerial decision-making and affects the business environment (Hofstede 1980). As a result, social embedded ties between Chinese organizations are quite common (Egelhoff 1984; Ouchi 1980). An MNE accustomed to building trust in business relationships at home is more inclined to understand information-sharing in order to operate more effectively abroad.

For US affiliates of Chinese firms, this relationship may be different if the firm through its affiliate employs a strategy that involves serving ethnic customers. For Chinese firms that follow this strategy, the US affiliate can become socially embedded within the ethnic community, resulting in enhanced information sharing and reduced unfamiliarity costs. Domestic firms (or in the present context, US firms) may be unable to achieve social embeddedness in these ethnic communities, especially when normative distance is high. Several Chinese banking executives have suggested that it takes more than using bilingual signs to gain the trust of Chinese consumers in the United States. Within a local Chinese community, liability of foreignness falls dramatically and in fact becomes a benefit for US affiliates of Chinese firms that adhere to a strategy that focuses on ethnically similar customers. Moreover, consumer ethnocentrism is dampened for firms that emphasize a local ethnic strategy.

Social embeddedness by Chinese firms operating in the United States can also be useful for US firms seeking to gain access to the Chinese market. A US affiliate of a Chinese multinational can draw upon its social network in China to provide services to US firms. For this niche strategy, it is less critical to become social embedded with host country firms and institutions. Thus, a US affiliate of a Chinese firm can attenuate some pressures to achieve external legitimacy by serving US customers seeking expertise on expanding into China.

Clustering with ethnically similar customers and competitors

Foreign firms tend to establish affiliates near ethnically similar populations (Shaver and Flyer 2000). As such, large local Chinese populations within the United States are likely to be able to support high local density of US affiliates of Chinese firms. In these environments, Chinese business practices become legitimized. Moreover, unlike US affiliates of firms from other developed countries, US affiliates of Chinese firms are likely to emphasize competition, which underscores the notion of strength in numbers – firms operate in a network of interdependent relationships developed through collaboration with the objective of deriving mutual benefits (Lado et al. 1997). A limitation of this "location" strategy is that legitimacy remains a problem in local markets with a low density of US affiliates of Chinese firms – that is, in the long term there may be constraints to this strategy. As a result, Chinese MNEs need to consider other actions to temper Chinese-specific LOF in the United States. One means of addressing this concern is to contribute to the local community.

Contributing to the local community

Often, multinational enterprises make local contributions because of government pressure, as a means to gain acceptance in the host country, to show corporate goodwill, or all of the above. These contributions may ameliorate host country concerns about foreigners exploiting the local market and increase the foreign firm's legitimacy in the host country. Eventually, such contributions might turn outsiders into insiders (Eden and Molot 1993). Japanese auto multinationals, for example, became successful insiders in the Canadian auto industry through their contributions to the Canadian economy (Eden and Molot 2002). Local contributions, however, do not always guarantee that the local affiliate of a foreign MNE will be accepted unconditionally by the local community. For example, Unocal built schools and hospitals in Myanmar and still faced substantial criticism from non-governmental organizations and other stakeholders.

Building schools and hospitals may be suitable acts of goodwill by MNEs operating in emerging markets; however, the nature of contributions in a developed market requires careful thought. One possibility is to establish university scholarships for less affluent US citizens, or make unconditional contributions to charities such as the Salvation Army, United Way or the American Heart Association, or perhaps to worthy youth organizations such as the Boy Scouts and Girl Scouts of America. These actions are likely to be viewed favorably by US citizens.

Building US–China relations

Another coping strategy for Chinese MNEs is to develop industry associations and lobby groups within the United States to help build US–China economic relations. Examples are the Committee of 100, made up of US and Chinese business and government leaders, and the US–China People's Friendship Association. These business associations are similar to the government-to-government associations, such as the US–China Joint Commission on Commerce and Trade (JCCT). Such groups can help overcome liability of foreignness and change the perception of Chinese firms from "outsiders" to "insiders" (Eden and Molot 1993, 2002). These associations can also address US perceptions of Chinese trade and FDI irritants.[9]

Another coping strategy could be to focus on Chinese parent MNE's activities at home. Chinese MNEs might also seek, with the help of the Chinese government, to address US human rights concerns about China, especially labor conditions in Chinese factories. Chinese firms could lobby for lowering (or speeding up the reduction of) entry barriers for US products and firms into China. Improved enforcement of Chinese laws (for example, against counterfeiting) where violations have adversely affected multinational firms operating in China would also be welcome in the United States. These gestures are likely to have positive spillover effects that can reduce some of the negative stereotypes and perceptions of Chinese firms held by the US public.

Learning from early entrants to the US market

We have argued above that Chinese MNEs are latecomers to the US market. Particularly in terms of cognitive institutional distance, Chinese MNEs are now facing barriers similar to those faced by earlier Asian entrants from Japan, the Republic of Korea and elsewhere. Therefore, studying the problems faced by earlier Asian entrants, their strategies, and their successes and failures can be useful learning tools for coping with LOF costs (for details, see Curtis Milhaupts, Chapter 7 in this volume).

Can Chinese executives learn anything from the US experiences of Japanese firms during the 1970s and 1980s? The answer is yes; however, there were both successful and unsuccessful Japanese operations in the United States. In terms of successful operations, Honda used sequential investment to pave the way for US expansion. First, Honda made a small investment – building a motorcycle production facility in Marysville, Ohio, "as an experiment to see if the company could eventually produce autos in North America" (Koenig and Ohnsman 2008). The MNE accumulated local market knowledge in the United States and then proceeded to increase investment with a large-scale auto production facility. Even though Honda's North American motorcycle production is now being discontinued, its Greenburg, Indiana, auto plant – its sixth vehicle assembly plant and thirteenth plant of any type in North America – began production in November 2008.

Despite many successes, some prominent Japanese firms encountered difficulties with their US operations. For example, Sony acquired Columbia Pictures (ICMR 2004). Financial analysts criticized Sony's venture into the movie business for a lack of synergies. In 1994, Sony reported a $2.7 billion write-off of this investment. Another firm that failed with its US operations is the Mitsubishi Estate Company, which purchased the Rockefeller Center in New York City. In 1995, a bankruptcy law filing by the Rockefeller Center enabled the Japanese firm to avoid additional cash infusions into the property although Mitsubishi Estate Company still owned $190 million in tax obligations (Hansell 1995; Strom 1995).

A second example is Toyota, which produced its first US-made vehicle at the New United Motor Manufacturing Inc. (NUMMI) plant in a joint venture with General

Motors. The MNE used this joint venture as a means to gather valuable knowledge about labor unions and US suppliers, not only as a mean to produce cars. Toyota has achieved success in the US market, and has contributed a great number of jobs and $14 billion in wages to the US economy in 2003 (Hill 2005).[10] Long seen as a successful example of Japanese entry into the US market, the expected closing of NUMMI shows that even long-term positive relationships can go sour.[11]

Although some academic scholars have proposed "springboard" approaches for emerging-market firms as a means to catch up to rivals operating in the United States (Luo and Tung 2007), the Honda and Toyota examples illustrate that a sequential or incremental approach can produce favorable results with less risk. Our discussion of two failed acquisitions is not an attempt to dissuade Chinese firms from using acquisitions as a mode of entry, but rather to underscore that the challenges involved in making large-scale acquisitions involve many issues, such as exploiting synergies between the acquiring firm and a target firm, and overpaying for a target firm, in addition to potential obstacles stemming from integration, institutional distance and cultural distance, among others (Morck et al. 2008).

5.7 CONCLUSIONS

In this chapter, we have explored the socio-political costs that Chinese multinationals face when engaging in foreign direct investment in the United States. Our framework underscores the LOF challenges facing many Chinese investors. Some firms may have avoided issues raised in our framework by taking very small stakes in a number of publicly traded firms rather than controlling stakes or acquisitions of Chinese and foreign companies (US–China Economic and Security Review Commission Hearing, July 5, 2007). In effects, their investments are so small they are invisible to federal authorities, reducing their firms' LOF costs.

Our interest lies with those Chinese firms that make investments (whether *de novo* or through mergers or acquisitions of US firms) satisfying the minimum 10 percent threshold to qualify as foreign direct investment in the United States. Where Chinese investments do qualify as FDI, the entering firm faces an array of socio-political costs, known as liability of foreignness, that raise the costs of doing business abroad for Chinese MNEs. These higher costs, unless offset through proactive strategies by the MNE parent and/or its US affiliate, will reduce profitability and could impair long-run survivability of the US affiliate. In sum, we have sought to link socio-political costs and institutional distance between the United States and China, and outlined some strategies that Chinese MNEs can use to offset these costs. Our work is preliminary and somewhat speculative. We hope that it encourages executives and other scholars to dig deeper into both the costs and successful coping strategies that Chinese firms face in the United States.

NOTES

* This chapter was prepared in the context of the Deloitte–Vale Columbia Center on Sustainable International Investment project on "Is the US ready for FDI from China?" The authors have benefited

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10. Toyota Motor North
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11. For an article on NU
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from the research assistance of Kehan Xu and helpful discussions with David Fagan, James Groff, Mark Kantor, Kris Knutsen and Karl P. Sauvant.

1. "National treatment" means that foreign investments and investors receive the same treatment inside a country as do local investors and investments. Chapter 11 of the North American Free Trade Agreement (NAFTA), for example, guarantees national treatment to investors and investments within North America.
2. There are, of course, exceptions, most notably the forced expropriation of foreign-owned petroleum assets in Venezuela. Vernon (1998) was perhaps the first international business scholar to foresee the rise in anti-FDI sentiment in Latin American economies in the early years of the twenty-first century. See also the 2007 *World Investment Report* (UNCTAD 2007).
3. We assume an intermediate ownership strategy (for example, equity joint venture) involves a local partner.
4. Chinese organizations investing in the US need to seek counsel in the United States to have a full understanding of the regulatory requirements in the US. Note that our analysis does not cover US regulations related to imported products from China (for example, US anti-dumping and countervailing duties, health regulations, safeguards, trade with state-owned enterprises and WTO commitments). Note also that not all US regulatory institutions raise costs for Chinese entrants. For example, the federal EB-5 Immigrant Investor program offers foreign investors who locate in poverty-stricken areas of the United States an opportunity to get permanent residency for entrepreneurs and their family members (Jordan 2007).
5. We provide a more detailed discussion in our analysis of the Foreign Corrupt Practices Act; however, this distinction is also relevant to the applicability of the other laws to the US affiliate and/or the Chinese parent firms.
6. That also includes US citizens living abroad, even if they are employed by non-US organizations.
7. In fact, the fastest-growing locations for transfer pricing professionals are Shanghai and Hong Kong (China).
8. See Chapter 3 by David Fagan in this volume.
9. The USTR's annual report to Congress on Chinese barriers facing US products and firms provides a useful summary of trade and investment irritants from the US perspective (USTR 2007). The Congressional Record Service report (CSR 2007) also provides useful background on US–China trade issues, along with several GAO reports.
10. Toyota Motor North America, Inc. commissioned the Center for Automotive Research, a non-profit research group, to complete an assessment of its economic and workforce contributions in the United States.
11. For an article on NUMMI closing see http://www.businessweek.com/autos/autobeat/archives/2009/08/nummi_to_close.html.

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