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The Governance Environment and International Business: Frictions between rule-based and relation-based societies and the strategic and policy implications

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Abstract

Classical economics uses economic factors, such as productivity and factor endowment, to explain variations in economic performance across nations. It fails to explain why nations persistently deviate from the most efficient mode of economic activities. Cultural theorist use cultural differences to explain why some countries are rich and others poor. They cannot explain why countries with a similar cultural origin have contrasting economic performance. Institutional theorists propose that nations diverge in economic performance because of particular institutional arrangement resulting from different paths of institutional change. Following the institutional approach, we propose a framework that distinguishes two main types of governance environment: rule-based vs. relation-based, and argue that the variations in the national governance environment affect how international business is conducted and protected. This article introduces the framework and a series of studies based on the framework on how governance environment affects international business such as investment, trade, management, and marketing.

Keywords: governance environment, rule-based, relation-based, international business

Introduction

The comparative study of economic development by economists, rooted in Adam Smith, David Ricardo, and Eli Hecksher and Bertil Ohlin, had been for a long time predominately focusing on national differences in economic factors, such as productivity and input factor endowment (see, e.g., Hill [2003] for a review of these thoughts). While their theories are built on solid economic foundation and rigorous logic, they cannot explain why countries with abundant factor-endowment remain poor, or why not all countries adopt the same most efficient mode of production to create wealth.

To solve this puzzle, scholars of culture try to explain the divergence in economic development across countries by using culture as the main explanatory variable (Harrison & Huntington, 2000, Hofstede, 2001). Their main argument is that it is the difference in national cultures—values and norms—that determine the process and the outcome of economic development. For example, Hofstede attributes the rapid economic growth in East Asian countries to the effect of Confucian culture (Hofstede, 2001) (similar to Weber's argument of the effect of the Protestant ethics on the rise of capitalism in the West (Weber, 1958 (1904-1905)). While the cultural approach contributes to the understanding of the difference in economic development by bringing our attention to the importance of culture, it fails to explain why countries with similar culture have diverging economic development levels (e.g., pre-reform China, China under reform, Taiwan, Malaysia, Indonesia and Singapore all have dominant Chinese culture and have different economic development levels) and countries with difference cultures converge in economic development levels (e.g., Germany, the U.S., and Japan have different national cultures and yet have similar economic development levels). Furthermore, the cultural scholars treat culture as the ultimate determinant, ignoring the fact that the political and economic systems also shape culture (Li, 2005a).

A major breakthrough in understanding international variations in economic development is made by the institutional approach taken by economic historians. They examine variations in institutional arrangements across countries to explain why some countries achieve fast economic development while others fail to do so. In his seminal book, *Institutions, Institutional Change, and Economic Development*, Douglas North argues that it is the institutional arrangement and the resulting path-dependence on such arrangement that mainly contributes to the persistently diverging path of economic development (North, 1990). According North, institutions are the "humanly devised constraints that shape human interactions" in a society. They are the "rules of the game" that structure incentives in social, economic, and political exchanges. Organizations and individuals are the players in the game who respond to the incentives and try to maximize their gains in the game. Institutions fundamentally determine economic performance of a society through their incentive structure and their efficiency in lowing transaction costs. Differences in economic performance between countries are primarily due to the different paths in institutional changes over time.

North distinguishes two types of institutional constraints: formal and informal constraints. Formal constraints are explicit devises by humans, including laws (constitutions, civil and commercial codes, and criminal codes), political and economic rules, and contracts. Formal constraints are vitally important for a society's social order and economic performance. However, formal constraints usually consist of a small part of all institutions

that shape human interactions in a society. The other, larger part of the institutions that govern social interactions are the informal constraints. The informal constraints include values, norms, and conventions. Informal constraints "come from socially transmitted information and are a part of the heritage that we call culture."

The relationship between the formal and informal constraints is complex. Informal constraints form the bedrock for formal constraints. For example, the value judgment that "murder is wrong" is an informal constraint. Based on this moral code, formal constraint may be made, such as a law that declares that murder is a crime of death penalty. Strong informal constraints may increase the efficiency of formal constraints. For instance, in societies where people highly respect the law, most act legally voluntarily, and the enforcement of contracts may also be less costly. At the same time, formal constraints may influence and reinforce informal constraints. Some scholars arrive at a similar conclusion from the perspective of social trust (Fukuyama, 1995, Pearce, 2001). They argue that societies in which the rule of law is better enforced tend to have a higher level of generalized trust (i.e., trust among unrelated parties). Formal constraints may change very fast, literally over night, such as government's issuing a new law; whereas the informal constraints change much more slowly. For instance, a new culture may take a century to evolve.

The institutional framework proposed by North provides the foundation to examine why countries differ in business transactions, management, and economic performance. However, North's framework is a general model. It does not explicitly specify countries into different groups of institutional environments in terms of business activities and economic development. With the groundbreaking work done by North, more specific efforts are needed to help us understand what types of institutional environment are conducive to economic development and how different types of institutional environment affect the way business is conducted across countries. Many researchers have applied North's framework to analyze economic development of a single country (Li, Li, & Zhang, 2000, Qian & Weingast, 1997) or across countries (Acemoglu, Johnson, & Robinson, 2002).

Among these attempts, one novel approach is to examine the variations in the national governance environment and how such variations affect business and economic activities within and across countries (Dixit, 2003, Li, Park, & Li, 2004, Li, 1999, Li & Li, 2000). In this article, I will introduce a framework that is first proposed by Shuhe Li (1999) and expanded by him and others (Li & Filer, 2004, Li, Karande, & Zhou, 2005, Li, Park, & Li, 2004, Li & Samsell, 2005, Maurer & Li, 2004) on the governance environment that distinguishes two different types of governance mechanisms, rule-based and relation-based governance, based on the social, economic, and political conditions of a society, and review studies that are based on this framework on how variations in national governance environment affect international business.

Variations in Governance Environment

Governance, broadly defined, refers to the mechanism individuals and firms use to protect their interests in social exchanges, such as business transactions (Li & Filer, 2004). In different societies, people use different types of governance mechanism to protect their rights. For example, in a society where laws are fair and efficient, people tend to rely on the court to solve business disputes. In contrast, in a society where laws are opaque and

judges are corrupt, people will resort to private means to settle business disputes. Thus the social environment, to a great extent, shapes the type of governance mechanism people use. Based on this observation and extending others' studies (Globerman & Shapiro, 2003, Kaufmann, Kraay, & Zoido-Lobaton, 1999), Li and Filer use the term "governance environment" to refer to the set of social, political, economic, and legal institutions that facilitate or constrain the choice of governance mechanism in a society (Li & Filer, 2004). Following this line of reasoning, Li et al. have developed a framework that classifies countries into four different groups based on weather they rely on public rules or private relations to govern economic transactions (Li, Park, & Li, 2004).

Rule-based and Relation-based Governance Systems

The notion of rule-based and relation-based governance system is first proposed by Shuhe Li (1999). According to Li and his associates (Li, Park, & Li, 2004, Li, 1999), if we examine the governance environment at the societal level from the political, legal, economic, and social perspectives, we can derive two contrasting systems: *rule-based* and *relation-based* governance systems based on how people protect their property rights and contracts.

In most developed societies, we observe that firms and individuals primarily rely on public rules—laws and government regulations—to resolve disputes and enforce rights and contracts. We call this reliance on public ordering a rule-based governance system. A rule-based governance environment must satisfy the following conditions: the public rules governing economic exchanges (such as laws, state policies and regulations) are fairly made; the rule-making, rule-adjudication, and rule-enforcement are separate; rule-enforcement is fair and efficient; and public information infrastructure (such as accounting, auditing, and financial rating) is highly reliable and accurate. As a result of the above conditions, citizens and organizations predominantly rely on public ordering in governing transactions.

The above features imply that rule-based societies tend to be mature democracies. For instance, for the laws and rules to be fair, a society must ensure fair participations of all interest groups in law-making, which requires a representative democracy; for law-interpretation to be impartial, judges must be independent of political influence, which implies checks and balances between different branches of the government; and for the enforcement to be impartial and efficient, again, the executive branch has to be answerable to the constituents and be checked by the legislative and judiciary branches. This is why mature democracies share many commonalities (such as checks and balances, independent courts, and frequent and fair elections with universal suffrage), yet non-democracies may take any forms (ranging from monarchy, military rule, communist rule, to civil war and anarchy). Rule-based societies tend to have similar rules, yet non-rule-based societies may take different forms of private enforcement mechanisms to govern transactions (e.g., community enforcement, private network enforcement, kinship enforcement, or mafia-dominated enforcement). In other words, while rule-based societies converge to the above profile (e.g., highly rule-based societies are all mature democracies), societies that lack a rule-based governance environment vary widely ranging from warring states with complete chaos to tightly controlled and highly efficient authoritarian rules.

We observe that a specific group of non-rule-based societies that rely on private ordering and are very efficient in governing social exchange, such as

the East Asian societies in general and the Chinese society in particular, that have been experiencing rapid economic growth. In addition to the absence of fair and efficient public rules due to the missing of any of the above conditions necessary for a rule-based governance system, these societies have the following in common: they all have an effective governance environment based on private enforcement that can effectively regulate markets and resolve disputes, which is called a *relation-based governance system*. A relation-based society has the following characteristics: public rules (laws, government policies, and government regulations) tend to be less fair (due to the lack of checks and balances); the executive branch of the government tends to overshadow the legislative and judiciary branches and tends to be controlled by a dictatorial ruling elite; courts and judges are controlled by the ruler(s); industries and markets tend to be controlled by a small number of insiders (i.e., people who have connections with the ruler(s)) and closed to outsiders; officials and business insiders tend to be locked into a corruption-bribery relationship; there is a strong network in industries and markets based on private information and private enforcement. For example, if someone is said to have broken the (unwritten) norms of the trade in an industry, the words of mouth by other insiders will effectively put him out of the market.

Based on the rule-based vs. relation-based framework, we have proposed a typology of four types of societies: (1) societies that rely on rule-based governance environment (most developed countries); (2) societies that lack fair and efficient public rules and rely on relation-based governance environment (developing countries with strong relation-based networks); (3) societies that are rule-based and yet have strong relation-based networks (such as Hong Kong); and (4) societies that lack fair and efficient public rules and lack efficient and effective relation-based networks (e.g., countries in civil war or chaos).

FIGURE 1

Types of Governance and Economic Systems

		Prevalence of Rule-based Governance	
		Extensive	Limited
Prevalence of Relation-based Governance	Limited	(Type 1) Developed economies	(Type 4) Countries in civil war or rapid transition
	Extensive	(Type 3) Economies that play mediating roles (e.g., Hong Kong)	(Type 2) Some developing economies

Source: Based on Li, Park, and Li (2004).

It has been observed that the relation-based governance system (Type 2) has helped the East Asia countries achieve rapid economic development, taking the advantage of low (fixed) costs of governance (Li, 1999). It is also noticed that these traditionally relation-based countries in East Asia are now establishing new public rules with fast paces. These observations prompted scholars to focus on the relation-based governance system (Type 2) and the transition from relation-based to rule-based governance (Type 1). Table 1 presents a summary of the contrasting features of the two systems.

TABLE 1

Differences between Relation-based and Rule-based Governance

Relation-based Governance	Rule-based Governance
Relying on private and local information	Relying on public information
Complete enforcement possible	Enforcing a subset of observable agreements
Implicit and non-verifiable agreements	Explicit and third-party verifiable agreements
Person-specific and non-transferable contracts	Public and transferable contracts
High entry and exit barriers	Low entry and exit barriers
Requiring minimum social order	Requiring well-developed legal infrastructure
Low fixed costs to set up the system	High fixed costs to set up the system
High and increasing marginal costs to maintain	Low and decreasing marginal costs to maintain
Effective in small and emerging economies	Effective in large and advanced economies

Source: Li, Park, and Li (2004).

It should be noted that all human societies, including relation-based ones, have formal rules to a varying degree. What distinguish relation-based societies from rule-based ones is not that the former does not have any formal rules; it is that people in the former tend to *circumvent* formal rules because the rules and the enforcement tend to be unfair, particularistic, and corrupt.

How Do People Govern Transactions in a Relation-based Society?

Unlike rule-based society, where the protection of transactions relies on public laws, in a relation-based society, firms rely on three private monitoring mechanisms to govern their rights in transaction. They are ex ante monitoring capability, interim monitoring capability, and ex post monitoring capability. Private ex ante monitoring capability refers to the effort invested by a transaction party before a business deal is made. In the absence of public information and enforcement, a firm must privately investigate its prospective transaction partner in terms of his/her track record and reputation. If the prospect has cheated, do not deal with him/her. If the prospective partner does not have a stable pool of business partners or clients, it implies that he/she may have a bad reputation and is avoided by other insiders. Such prospect should be ruled out. Interim monitoring is the ability of one party to obtain on-going business and operation information about the other party, in terms of whether the other party is on-track with project schedule, whether the other party has any financial trouble or disputes. In a relation-based society, such information is not publicly available through credit investigating agencies. This is why news of financial insolvency of a firm in a relation-based society tends to cause large scale panic because due to the lack of reliable public financial data, people do not know whether other firms may have also involved with the insolvent firm and thus are adversely affected. As a result, people stop lending to or withdrawal deposits from other likely involved firms (a cascade effect). Thus one must invest in the capability of obtaining private and reliable information. The third monitoring mechanism, private ex post capability, is most important. It refers to the ability to remedy or deter cheating or other opportunistic behaviors of the other party, in the absence of resorting to public rules such as the court (which tend to be corrupt, unfair, and inefficient). For instance, it is not uncommon for a promisee to resort kidnapping to force a promisor to fulfill a promissory obligation (which may be an informal, oral promise) in a relation-based society. For relation-based governance to work efficiently, private ex post monitoring must be effective and efficient. A news report (New York Times, 2004) about informal lending in China vividly describes such an ex post monitoring:

"Borrowers default on nearly half the loans issued by the state-owned banks, but seldom do so here on money that is usually borrowed from relatives, neighbors or people in the same industry. Residents insist that the risk of ostracism for failing to repay a loan is penalty enough to ensure repayment of most loans...[as one lender puts it,] 'if it weren't a good friend, I wouldn't lend the money.'...Violence is extremely rare, but the threat of it does exist as the ultimate guarantor that people make every effort to repay debts. 'Someone can hire a killer who will chase you down, beat you up and maybe even kill you'."

The Costs and Benefits of Relation-based Governance System

Since we observe that advanced countries all rely on public rules for governance, we may quickly arrive at the conclusion that the relation-based governance is categorically inefficient and thus detrimental to economic development. But such a conclusion is premature. Relation-based governance

systems are not all inefficient and thus hinder economic growth. Under certain conditions, relation-based governance can be quite efficient and effective due to a different costs structure.

A rule-based system requires a large investment in legal infrastructure. It needs the establishment of the three-branch government. Specifically, the court system must be well-functioning, independent, and well-funded. The society must train sufficient number of judges, who must be impartial and well-paid, and independent of political or military influences. It needs an army of well-trained lawyers. The police must be well-trained and uncorrupted. To establish all these is costly and takes a long time. Thus the rule-based system has high fixed costs. But once the system is established, the incremental cost of drafting and enforcing one more contract is relatively low—whether the system enforces one contract or one million contrasts, the fixed, upfront investment for the legal infrastructure is the same (and sunk), and the marginal cost (the incremental cost of enforcing an additional contract) is minimum.

In a relation-based society, business can thrive with minimum social order. As long as there are no rampant robberies and violence, business can be conducted and governed by well-functioning social/industrial networks maintained by private players (individuals or firms). On the other hand, relation-based governance has few fixed costs (since it does not rely on a nationwide legal infrastructure), but high (and increasing) marginal (incremental) costs of establishing new relations, since cultivating relations becomes increasingly costly when one's private network expands from family members to strangers. This is why in a relation-based society, people first do business with family members, and then with friends and people they know. They try to avoid dealing with strangers, for it takes a long ational Business

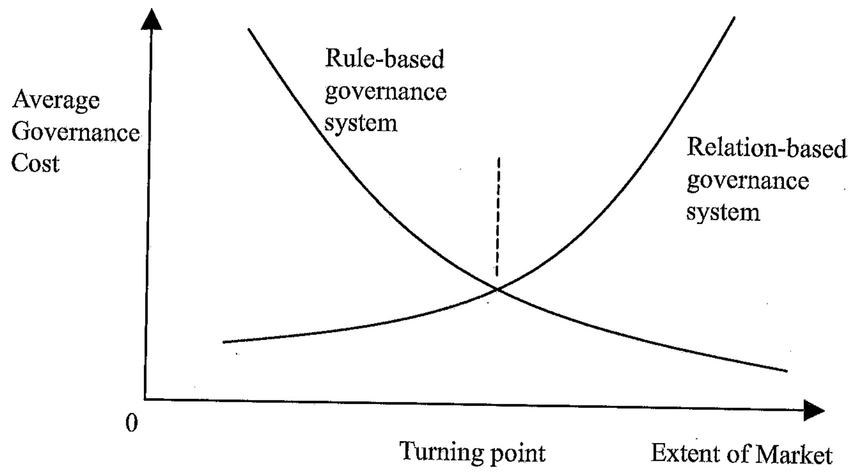
.ationships and the costs of private monitoring and vith strangers.

.e and scope of the economy are small, relation-based be effective and efficient, as the society avoids costly investr. developing and maintain legal infrastructures. People and firms are constrained to and content with dealing with family members, friends, and people in closely-knit circles. We argue that the East Asian economies have relied on the relation-based governance to jump-start their economic development in the early stage, effectively avoiding the large investment required for establishing a legal infrastructure needed for a well-functioning rule-based governance system. As is illustrated in Figure 2, when the market is small, the average governance cost is lower in relation-based societies, giving them a comparative advantage during the taking-off stage of their economy.

However, when an economy expands from local to national and international in scope, the relation-based governance becomes inefficient, as the average cost of finding and establishing relationships rises and thus the average cost of governance surpasses that of rule-based economies, as illustrated at the turning point in Figure 2. At this point, a relation-based society begins to lose its comparative advantage in governance costs to rule-based societies. It faces the pressure to migrate toward a rule-based governance environment. Postponing the migration (or transition), which may be caused by the resistance of people who are deeply entrenched and vested in the existing relational network, hinders a country's further development. This point will be further elaborated later.

FIGURE 2

The Transition from Relation-base to Rule-based Governance



Source: Shuhe Li (1999).

Measuring the Governance Environment

The framework of rule-based and relation-based governance environment provides a new perspective to analyze an array of phenomena in international business. However, a major challenge is how to quantify the governance environment. For example, based on what can we say that China is a relation-based country, or U.S. a rule-based country? Li and Filer have developed an index to measure the degree to which a country relies on a relation-based or rule-based governance environment (Li & Filer, 2004). Based on the theoretical framework of Li (1999) and Li, et al. (2004), Li and Filer select and combine five indicators to construct a "Governance Environment Index" (GEI). The five indications are (1) political rights (citizens of rule-based countries tend to have more political rights), (2) rule of law (rule-based countries have stronger rule of law), (3) free flow of information (rule-based countries enjoy more free flow of information), (4) level of public trust (rule-based countries tend to have higher level of public trust), and (5) level of corruption (rule-based countries tend to have lower level of corruption). Data of the five measures are from the World Bank and other international agencies and academic surveys. They calculated the GEI for forty-four countries that have all the five indicators, representing a wide and balanced mix of developed and developing countries from different continents. The country with the highest GEI (most rule-based) is Norway, while China has the lowest GEI (most relation-based).

TABLE 2

Governance Environment Index

Country	GEI	Country	GEI
Finland	2.80	Czech Republic	0.14
Norway	2.68	Poland	0.10
Sweden	2.66	S. Korea	-0.03
Denmark	2.59	South Africa	-0.12
Canada	2.43	Bulgaria	-0.17
Netherlands	2.35	Croatia	-0.67
Iceland	2.31	India	-0.81
Australia	2.09	Argentina	-0.94
Ireland	1.90	Peru	-0.99
United Kingdom	1.87	Ghana	-1.08
United States	1.82	Romania	-1.09
Germany	1.73	Mexico	-1.17
Austria	1.69	Brazil	-1.66
Japan	1.64	Philippines	-1.94
Belgium	1.28	Venezuela	-2.13
Spain	1.18	Turkey	-2.27
France	1.05	Ukraine	-2.41
Taiwan	0.92	Nigeria	-2.56
Portugal	0.81	Colombia	-2.64
Chile	0.79	Bangladesh	-2.85
Hungary	0.59	Russia	-2.99
Italy	0.54	Azerbaijan	-3.19
Slovenia	0.38	Pakistan	-3.39
Uruguay	0.30	China	-3.53

Source: Li and Filer (2004).

The Effect of the Governance Environment on International Business

Based on the framework of rule-based and relation-based governance environments, a series of studies have been conducted to analyze business patterns across countries in several fields, such as investment, trade, management, marketing, and information technology. The Governance Environment Index offers a useful measure to quantitatively study the relationship between governance environment and international business. In this section, we review some of the studies in this direction.

The Effect of the Governance Environment on the Mode of Investment

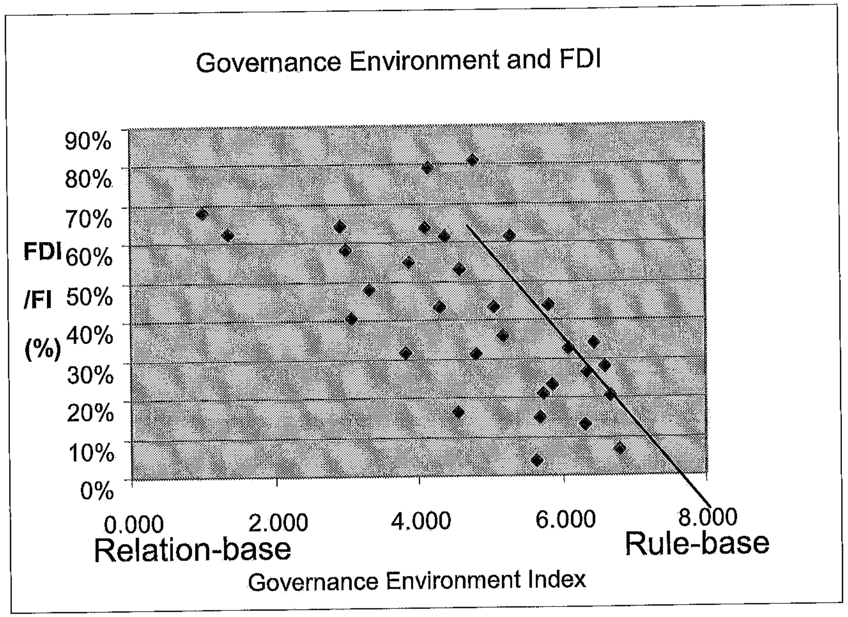
Li and Filer (2004) examine how various governance environments affect the mode of foreign investment. There are two modes of foreign investment: foreign direct investment (FDI) and foreign portfolio investment (FPI). In FDI, the investor not only invests, but also manages; whereas in FPI, the investor is a passive investor; he/she only buys shares of a listed firm's stock or bonds from the public security market, relying on public information (annual reports, analysts rating, etc.) for governance. Generally, if an investor has less than 10 percent ownership in a firm, he/she is considered a portfolio investor (Hill, 2003).

Existing theory claims that good governance environment (or rule-based governance environment) attracts more foreign direct investment (FDI) (Globerman & Shapiro, 2003). However, the existing theory cannot explain why countries with a poor legal system and weak protection of property rights, such as China, attract so much FDI. The conventional wisdom would argue that it is China's huge market that attracts a large amount of FDI, *despite* the weak legal system.

Based on the rule-based and relation-based framework, Li and Filer argue that in countries with a weak legal system (e.g., relation-based governance environment), investors tend to choose direct investment over portfolio investment, for the former is relatively easier to protect through private, or relation-based, means, whereas portfolio investment relies entirely on high quality public information and public protection, which relation-based countries lack. Li and Filer's statistical analysis shows that when foreign investors invest in relation-based countries, they tend to choose direct over indirect (portfolio) investment, controlling for the restrictions on the capital market imposed by the government. Their findings imply that China attracts a large amount of FDI *because* of, not *despite*, the weak legal system.[1]

[1] There were restrictions on foreign portfolio investment and that the Chinese government has been actively attracting FDI. In Li and Filer's statistical analysis, they controlled for capital market restrictions. It is true that certain part of China's portfolio investment market was restricted for foreigners. But its stock market has been open to foreigners (in the "B-share" market) since it was open to domestic investors in the early 1990s. There was no restriction for foreigners to invest in the B-share market (actually it was specifically for attracting foreign capital). However, the B-share has had a PE ratio several times lower than the "A-share" market for domestic players, reflecting a lack of interest from foreign investors (when they had a choice to invest elsewhere, which was not the case for Chinese domestic investors).

FIGURE 3



Governance Environment and FDI

Note: The scale of GEI is adjusted to 0 (most relation-based) to 8 (most rule-based), with 4=mean. FDI/FI = (foreign direct investment)/(total foreign investment).

Source: (Li, 2005b).

In a study on the relationship between the quality of accounting standard and governance environment, Li and Pinsker (2005) found that rule-based countries tend to have higher quality of accounting standard. Given the fact that portfolio investors reply more on public accounting and auditing to govern their investment than direct investors, this finding further supports Li and Filer's argument that investors tend to choose direct investment over portfolio investment when investing in countries with poor public protection of property rights.

Why some Countries Trade More—Governance Environment Matters

Li and Samsell examine the effect of the governance environment on trade flows between countries (Li & Samsell, 2005). Rule-based countries tend to have clear and universal rules that are open and applicable to everyone; whereas relation-based countries tend to rely on personal connections. Trading rules are opaque and differ depending on how well an importer is connected. As a result, it is easier for anyone, including both domestic and foreign firms, to do business in rule-based countries than in relation-based countries. Using the United Nation's data, Li and Samsell find that (1) rule-based countries trade more than relation-based countries; (2) on average, trade flows between two rule-based countries have the highest average volume, whereas trade flows between two relation-based countries have the lowest volume (because relations are not transferable from one country to another, there is no savings in trading costs between two relation-based countries); and (3) all countries prefer to buy (import) from rule-based (note: not relation-based) countries.

A New Perspective on International Management

The framework of rule-based and relation-based governance can be applied to the comparative studies of management (Li, Park, & Li, 2004). In international management, one of the major issues is expatriate failure, which refers to the failure of high-level managers sent from the home country to manage host country employees. Evidence shows that the majority of expatriate managers from the West fail in their job assignments in developing countries and that such failures commonly inflict enormous financial and opportunity costs on the expatriate's employer (Black & Gregersen, 1999, Caudron, 1991). Yet, existing research has failed to go beyond attributing such failures to "cultural differences" to offer any useful diagnostic tools to help Western expatriates improve, other than "culture-sensitivity training" (Hodgetts & Luthans, 2000). Using the framework of rule-based and relation-based governance environments, Maurer and Li argue that one of the major reasons for such a failure is the friction in working relationship between rule-based expatriate executive and relation-based local employees (Maurer & Li, 2004). They postulate that the perception of working relationships between rule-based expatriates and relation-based local employees differs in the following dimensions: (1) terms of the working relationship, (2) scope of the working relationship, (3) duration of the working relationship, (4) time needed to develop the working relationship, (5) cost of developing the working relationship, and (6) speed of learning the relationship, as shown in Table 4.

Maurer and Li believe that to be successful, a Western, rule-based expatriate cannot passively adopt the local relation-based working relationship, he/she must actively lead the firm to evolve into a rule-based working environment with minimum disruptions. Their study offers a diagnostic tool to help Western expatriate form effective working relationship and lead the local employees in the transition from relation-based to rule-based working relationship.

TABLE 3

Expectations of Working Relationship Formation between Rule-based and Relation-based workers/managers

Dimensions of expectations	Relation-based workers/managers	Rule-based workers/managers
Terms	Vague	Clear
Scope	Wide and deep (it may include all sorts of activities and relationship between an employer and a worker)	Narrow and specific, task-oriented.
Duration	Long	Short
Time needed to develop the working relationship	Long	Short
Costs of developing the relationship	High	Low
Learning curve	Flat, slow learning process, since relations are secretive and particularistic	Steep, fast learning process, since rules are by their nature transparent, public, and general

Source: Maurer and Li (2004).

The Effect of Governance Environment on Market Structure

Marketing scholars have long observed differences in the manner in which market exchanges are conducted across countries. For example, in some countries, market channels tend to be more open to outsiders, market information are publicly available and more reliable, and transaction disputes tend to be settled through public ordering. In other countries, market channels tend to be exclusive and entry barriers tend to be high; publicly available market information tends to be unavailable and low quality, and disputes are settled privately. These variations have been attributed mainly to national culture and cultural distance (Erramilli, 1996, Lin & Germain, 1998, Ting-Toomey, 1988).

However, the cultural arguments cannot explain why countries with similar cultural backgrounds (e.g., Hong Kong vs. China) exhibit differences in market exchange arrangements, and thus provide little strategic guidance to multinational corporations (MNCs) in international marketing.

Based on the framework of rule-based and relation-based governance environments, Li, Karande, and Zhou explain how the two types of governance environment affect inter-organizational exchanges in the marketing channels context, including barriers to entry, information access, enforcement and dispute resolution, and scale and scope of exchanges (Li, Karande, & Zhou, 2005). They analyzed the case of the diamond industry in the United States (with rule-based governance) and China (with relation-based governance) and developed the following propositions: (1) market exchanges in a relation-based governance environment tend to have higher barriers to entry (costs of entry) than those in rule-based governance environments; (2) market channels in a relation-based governance environment tend to be more exclusive than those in rule-based governance

environments; (3) exchange partners in a relation-based governance environment tend to lack publicly available and verifiable information at both the market and firm level than those in rule-based environments; (4) exchange partners in a relation-based governance environment tend to have lower public trust than those in rule-based environments; and (5) relation-based markets tend to rely on the two transacting parties to enforce property rights and resolve disputes; whereas rule-based markets tend to rely on a third party for property right enforcement and dispute resolution in transactions; and (6) the scale and scope of market exchanges increase as the governance environment becomes more rule-based and less relation-based.

From Relations to Rules: the Greatest Leap Forward

As the scale and scope of the market expands from regional to national to international, relying on the relation-based governance to protect business transactions becomes increasingly costly and impractical. For example, according to the New York Times' informal lending story cited earlier, "more recently, local residents say, a lot of money has been flowing ... in other big cities, especially Shanghai,... Deals increasingly involve people who have no family or neighborhood connection, raising the risk of disputes." The advantage of relation-based governance—low fixed costs—will be overshadowed by the disadvantage—high and rising marginal cost, as illustrated in Figure 2, when the extent of the market expands beyond the turning point. At this point, the society that has been relying on relation-based governance must embark on a transformation process to become a rule-based society, in order to compete globally.

Such a transformation is evident in Asia and is particularly salient in China. The economic reform in China can be viewed as a great effort to establish a rule-based governance system. But the transition from relations to rules is not easy, as *The Economist* calls it "the greatest leap forward" (Economist, 2001). The following analogy of traffic control system in China vividly depicts the difficulty of such a transition.

Foreign visitors in China are surprised to see that on most major streets there are both an automatic traffic light *and* a policeman directing traffic simultaneously at intersections. They are even more surprised to realize that the two often operate in conflict. As a result, drivers are confused and accidents occur. This situation represents the epitome of the broader transition from a relation-based governance system (human directing traffic) to a rule-based governance system (automatic traffic lights). China is in the process of introducing new public rules. However, the question is: "Why does China use both systems simultaneously since they are mutually exclusive?" The answer is that if China stays with the policeman directing traffic, the system may never evolve into an automatic one. On the other hand, if China replaces the traffic police with an automatic system overnight, no one will obey it. In order to deal with this dilemma, China keeps both, inevitably causing confusion.

Such confusion is precisely what is happening in the governance environment in today's China. Guanxi, or private connections, is still dominating business transactions, but better and fairer public rules are being introduced. However, the newly introduced rules are most often merely ink on paper with essentially no effective and efficient enforcement. The lack of enforcement is further exacerbated by the fact that people do not respect the law. Using North's institutional framework, we can say that even though

China begins to set up a set of formal market-preserving institutions (economic laws and regulations), the informal institutions (values and norms that respect law and order) are weak. Without a strong informal institutional support, the formal institutions cannot function effectively and efficiently. At the same time, as China's economy rapidly expands, old guanxi network is not enough and is in decline. During the transition, firms may find that years of investment in cultivating guanxi may become less powerful as the reliance on guanxi in business dealings wanes. The declining of guanxi discourages firms from investing more in cultivating guanxi. And yet firms cannot entirely rely on the pubic ordering (laws and courts) either, as the latter is not effective or efficient. The combination of the decline in the relation-based governance and the infant stage of rule-based governance creates a governance vacuum, increasing the risk of doing business, as illustrated by the simultaneously directing traffic by a policeman and an automatic traffic light.

How far has China gone in the transition? On the positive side, we see that the government is writing more laws and trying to curb relation-based businesses (such as its efforts in anti-corruption, anti-smuggling, and divesting governments of direct business operations). On the negative side, we see that the level of corruption is not subsiding, and the major players in most sectors of the economy are cementing their relationships with the government, creating high entry barriers for new comers.

One of the features of the transition is the discrepancy in laws between what is newly written and what is practiced. In China, experienced business people know that laws are not followed by the words. Unfortunately, inexperienced investors from rule-based countries, reading these laws (most of them are adopted from mature economies such as Taiwan, which has a similar legal tradition), view the transition as an opportunity to invest, while some insiders view the transition as an opportunity to loot (taking advantage of the governance vacuum). What makes the situation worse is China's lack of publicly verifiable information about social exchange activities. Public business information is, in general, untrustworthy. This is why when analysts study the annual reports of listed Chinese companies, they pay particular attention to the colorful pictures (such as CEOs shaking hands with state leaders), rather than their income statements. Those pictures imply strong relationships with political leaders, which in turn implies good businesses, whereas income statements can be cooked, due to the lack of public enforcement on fraud.

Conclusion: Some Advices for Firms Doing Business in a Transition Society

The Fit between the Governance Environment and Business Practice

The framework of rule-based and relation-based governance systems offers a new perspective for researchers to study international business. It also provides a tool for policy makers and business executives to evaluate a society or a market in terms of its governance environment. For example, the Governance Environment Index (GEI) is a useful tool for international business executives to evaluate whether a country relies primarily on public rules or on private relations in governing business transactions. Such knowledge will help MNCs better formulate their investment strategies. A central message of our analysis is that the operation mode of an MNC has to fit the governance environment of the country in which it is doing business.

For example, in a relation-based country, investing in the secondary

market, such as the stock or the bond market, entails high governance risks, due to the lack of legal protection and reliable publicly available financial information. One of the most effective ways to capitalize on business opportunities in relation-based countries is through direct investment, which enables the investor to have better private protection. Cultivating relationships with key officials in relation-based societies, such as China, is a strategic behavior prompted by economic and legal imperatives rather than merely following a cultural tradition.

In addition to a general understanding of the nature of relation-based governance, investors need to develop a systematic tool to protect their interests through private means in a relation-based society. This task is especially difficult for the very reason that relation-based societies lack transparent and fair rules. Our analysis of the three types of information and monitoring may serve as a general strategy to privately protect investors' interests. Ex ante screening helps investors choose partners that tend to honor commitments; interim monitoring makes sure that they are on track to fulfill their promises; and ex post monitoring capability deters the partners' opportunistic and cheating behavior. Cases show that without the three monitoring capabilities, especially the ex post monitoring capabilities, conducting business in a relation-based society exposes one to a high likelihood of being cheated (Hogan, 1998, Li, 2004).

Relation-based Governance: a Double-edged Sword

There is little dispute that cultivating relations is necessary for business success in relation-based societies. However, we should understand the following caveats when using relations to advance and protect one's interests in a relation-based society. First, when a foreign firm uses relations to protect itself from opportunistic behavior or unfair competition by its local partners or competitors, the local partners or competitors may do likewise. And the local partners/competitors may have stronger relations (connections) in the country than the foreign firm, and the local players may use their relations opportunistically to the foreign firm's disadvantage (Li, 2004). Second, the use of relations may be unethical or illegal even in a relation-based society. For example, giving a gift to an official in exchange for a business license is an act of bribery. (Of course, one would argue that the monopoly over licenses by the government and the lack of fair rules in granting them are the root-causes of the bribery. This is why corruption is closely associated with relation-based societies.)

The Risks Associated with the Transition

As we discussed earlier, global expansion propels some relation-based economies to increase the transparency of their legal systems and to provide better public protection of property rights. These relation-based economies are evolving toward a rule-based system. The transition may be associated with a higher governance risk, as existing relations become less effective due to "end of game" expectations and to the fact that the nascent rules are not fully functional. In the interim there may be a vacuum of governance mechanism, as witnessed in a number of former communist economies in transition, such as Russia during most of the 1990s (Abdelal, 2001).

For investors from rule-based countries, doing business in a relation-based country undergoing transition is especially hazardous because of the associated governance vacuum during rapid transition. Furthermore, MNCs must balance their strategic resources between cultivating relationships and embracing the new rules. The choices of MNCs in a relation-based country may not only affect their operation, but also affect how rules are being set up in the host country.

In concluding this article, I would like to draw attention to the following caution in formulating business strategies in relation-based societies. Modern strategic planning is a systematic study of business operations that is developed in rule-based countries under the assumption that there exist publicly verifiable and reliable information. Business operations in relation-based societies are antithetical to modern strategic planning. Systematically studying business strategies in relation-based societies using verifiable and quantifiable data remains a challenge. In this article I introduce our studies on the issue of the governance environment and its effect on international business, hoping to draw the attentions of the international community on this emerging and important issue, and, in the process, to help government officials and business executives, especially the ones from rule-based countries, to be better prepared and equipped to successfully deal with the relation-based governance system and the challenge of the transition in relation-based societies.

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監管環境與國際商業：關係為本與制度為本的摩擦以及在戰略和政策上的含義

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摘要

古典經濟學家用生產力和生產要素來解釋各國經濟增長的不同，但是他們無法解釋為什麼生產要素無效率的組合會在一些國家長期存在；文化學家則將各國經濟發展不同歸咎於文化差異，但是他們無法說明為什麼文化傳統相同的國家經濟發展可以相去甚遠。制度經濟學家提出制度演進的不同是各國經濟增長不同的主要因素。根據這一思路，我們建立了一個監管環境對商業和經濟影響的理論框架。監管環境指一國社會制度的總和，這一制度總和限定了人們在交換中保護利益的手段。我們把各國的監管環境歸為兩大類：一類可稱為“關係為本”，一類為“法制為本”。本文將介紹這一理論在國際商業研究中的應用。

關鍵字：監管環境，關係為本，法制為本，國際商業。