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JOURNAL OF INTERNATIONAL BUSINESS RESEARCH

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ARTICLES

A COMPARISON OF AGENCY PROBLEMS IN TAIWANESE HIGH TECH AND TRADITIONAL CORPORATIONS

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ABSTRACT

The main objectives of the paper are to estimate the effect of ownership structure on a corporation's profitability and compare agency problems between high tech and traditional corporations. The study included four steps: descriptive statistics, multiple regression analysis, multiple regression analysis by size, and tests for homoscedasticity to refine our estimates. The results indicate that 1) traditional corporations have significant agency problems while high tech corporations have insignificant agency problems; 2) revenue growth rate was significantly associated with profitability for both large and small high tech corporations; and 3) revenue growth rate was significantly associated with profitability for small traditional corporations, but not for large traditional corporations.

INTRODUCTION

As the stock of many corporations is widely held by the public and managers of corporations have a great deal of autonomy, a potential conflict (agency problem) between managers (agents) and stockholders (principals) arises whenever a management team is not trying to maximize shareholders' wealth. "For example, it has been argued that managers of a large, well-entrenched corporation could work just hard enough to keep stockholder returns at a reasonable level and then devote the remainder of their efforts and resources to public service activities, to employee benefits, to higher executive salaries, or to golf (Brigham, 1995)."

Theoretically, the lack of entrepreneurship, unwillingness to take risks, short-term oriented decision-making, and the conflict between personal interests and the corporation's are some of the symptoms of agency problems. However, the separation of ownership and control of corporations will continue its trend due to the fact that managing a corporation requires experience, training, expertise, and a tremendous amount of capital in order for the corporation to survive, to realize economies of scale, and to compete globally.

Many empirical studies have evaluated the effect of separation of ownership and control on corporations' profitability. Two approaches were generally adopted based on theorems developed by Berle and Means (Berle, Means, 1932,1968):

1. Compare profitability of owner-operated corporations directly to that of manager-operated corporations (Kamerschen, 1968, Monsen et al., 1968), and/or
2. Study the impact of ownership's structure on corporations' profitability, as ownership structure could be a continuous variable in a cross-sectional dataset.

The findings are not only inconsistent but also inconclusive:

1) Percentage owned by the management group and profitability have a positive linear relationship (Hudson et al, 1992, Jensen & Meckling 1976, Niehaus 1989).
2) Percentage owned by the management group and profitability have a non-linear relationship (McConnell & SERVAES 1990, Morck & Vishny 1988, Stulz 1988).
3) Percentage owned by the management group and profitability have a positive (negative) relationship if corporations were small or medium (large) (Monsen et al 1968).
4) Ownership structure with higher concentration ratio could have positive, negative, or no effect on profitability (Admati & Zechner 1994, Hindley 1970, Leech & Leahy 1991, Neun 1986, Prowse 1992).5) There was no relationship between executive stock options and corporations' profitability (Loderer & Martin 1997).

All previous studies were based on cross-sectional datasets, which included corporations from industries of all categories. No study has compared the impact of ownership's structure on corporations' profitability among industries. As variation among industries could be quite significant, e.g. the characteristics of high tech corporations may well be totally different from those of traditional corporations, the agency problem of high tech corporations could behave differently than traditional corporations. To examine this issue, this study classifies industries into two categories: 1) High tech corporations which have higher revenue growth rate (41.48%) and higher profitability (4.81%); and 2) Traditional corporations which are deemed mature with an average revenue growth rate of 9.06% and lower profitability (1.96%).

The main objectives of the paper are to: 1) Estimate the effect of ownership structure on corporations' profitability of high tech and traditional corporations respectively; 2) Compare agency problems between high tech and traditional corporations; and 3) Provide implications for stockholders' wealth maximization.

METHOD OF ANALYSIS

Model specification

As the main feature of the paper is to estimate the agency problem of high tech and traditional corporations, our model specification is consistent with many previous studies:

Model 1 :$Y_i = a_0 + a_1X_{1i} + a_3X_{3\,i} + \epsilon_i$, i=1,2,…,n
Model 2 :$Y_i = b_0 + b_2X_{2i} + b_3X_{3i} + \epsilon_i$, i=1,2,…,n

Where,

Y= Return on total asset
X_1= Percentage of stocks owned by management
X_2= Concentration ratio of the largest five stockholders
X_3= Revenue growth rate.

In the models specified above,

Return on total asset (ROA) (Y) is to approximate corporations' overall profitability due to the fact that ROA is a comprehensive measure reflecting corporations' efficient use of asset;

1. Percentage of stocks owned by management (X_1) indicates the level of potential agency problems;
2. Concentration ratio of the largest five stockholders (X_2) indicates ownership structure; and
3. Revenue growth rate (X_3) is a key control variable to remove variations of profitability caused by other factors across corporations.

Models of many previous studies (Hindley 1970, Jensen & Meckling 1976, Monsel el al 1968) incorporated both percentage of stocks owned by management (X_1) and concentration ratio of the largest five stockholders (X_2) into the same regression equation. If X_1 and X_2 are highly correlated, the regression analysis would not be able to separate the impact of X_1 on Y from that of X_2 on Y and would end up with insignificant t-ratios. In fact, our preliminary descriptive analysis indicates that the correlation coefficients between X_1 and X_2 were 0.92 and 0.82 for high tech and traditional corporations, respectively. Hence, our models only include either X_1 or X_2 and their effects on profitability are estimated separately.

Estimation procedure

The first step of the study estimates descriptive statistics of all variables to provide an overview of the database. The second (preliminary) step, estimates models 1 & 2 for both high tech and traditional corporations separately using multiple regression techniques. Due to the fact that average profitability of traditional corporations is very low (1.96%), multiple regression models without an intercept are applied for the estimation of traditional corporations in order to enhance independent variables' explanatory power on the dependent variable. As a result, four equations are estimated in step two.

In the third step of the study, we include a size factor. Due to the fact that a firm's size affects its concentration ratio and our sample size (degrees of freedom) allows us to differ the effect of small size corporations from that of large size corporations, we divided our data base further into two size categories with total assets of NT$10 billion ($312 million) as the dividing point. Hence, we estimate eight equations in step three.

In the final (fourth) step, we check for the potential problem of homoscedasticity as all models are estimated based on cross-sectional data. We apply the "two sample variance F-test" technique to test the hypothesis that the mean square error (MSE) of the large size corporations = the MSE of the small size corporations based on the results from step three. Pending the results, if the assumption of homoscedasticity has been violated, we have unbiased but inefficient estimates in step two and we would need to focus our interpretation on the results of step three. Otherwise, we would need to focus on the results of step two due to the relatively larger sample sizes.

Data collection and treatment

We collected returns on total asset (Y) from the financial database of Taiwan Economic Journal, with Y equals [after tax net income + interest expenses * (1- tax rate)] / (average total asset). Percentage of stocks owned by management (X_1) was collected from corporations' accounting/auditing reports and X_1 equals (# of stocks owned by management) / (average total # of ordinary stocks outstanding). Concentration ratios of the largest five stockholders (X_2) and revenue growth rates (X_3) were collected from Quarterly Stock Market Summary reports, where X_2 equals (# of ordinary stocks owned by the five largest stockholders) / (average total # of ordinary stocks outstanding) and X_3 equals (total revenue of year t – total revenue of year t-1) / (total revenue of year t-1).

The database included a total of 399 public trading corporations in Taiwan in the year 2000. One hundred one corporations are classified as high tech corporations, including electronics, telecommunications, computer hardware, software, networking, information systems, etc. The rest (298) are traditional corporations such as clothing, textile, trading, agriculture, manufacturing, etc.

Because the government regulates financial and insurance corporations differently, they are not included in the database.

THE RESULTS

Descriptive statistics

Table 1 presents a statistical summary of all variables for the regression models of the second step. The results indicate:

1. Returns of total asset (Y) of high tech corporations were significantly higher than that of traditional corporations;
2. Percentages of stocks owned by management (X_1) and concentration ratios (X_2) were comparable in both high tech and traditional corporations;
3. Percentages of stocks owned by management (X_1) and concentration ratios (X_2) were highly correlated with the same distribution pattern; and
4. High tech corporations' revenue growth rates were significantly higher than that of traditional corporations.

Table 1: Statistical summary of all variables

High tech corporations				Traditional corporations			
Max.	Min.	Mean	SE*	Max.	Min.	Mean	SE
Return on total asset (Y)							
14.26	-5.69	4.81	3.52	15.54	-12.13	1.96	3.11
Percentage of stocks owned by management (X_1)							
69.34	5.00	23.16	11.75	79.77	2.12	23.48	15.03
Concentration ratio of the largest five stockholders (X_2)							
56.38	4.13	22.73	11.73	79.80	0.33	26.17	15.91
Revenue growth rate (X_3)							
281.60	-42.6	41.48	51.47	295.1	-100.60	9.06	39.06
* SE: Standard error.							

The results of Table 1 also imply that:

1. Agency problem of high tech corporations are significantly different from that of traditional firms, which confirms the validity and value of our initial assumption of the study; and
   a, The multiple regression models should only include either X_1 or X_2, but not both, as they were highly correlated.

Table 2 presents descriptive statistics of all variables by corporations' size for the regression models of the third step. The results indicate that:

2. Small high tech corporations were less profitable than that of larger high tech corporations and small traditional corporations were comparable to larger traditional corporations' profitability;
3. Both small high tech and small traditional enterprises have higher percentages of stocks owned by management and concentration ratios; and
4. Both large high tech and large traditional corporations have higher revenue growth rates than their smaller peers.

Table 2: Mean values of all variables based on corporations' size

High tech corporations		Traditional corporations	
Large size	Small size	Large size	Small size
Average size in NT$ billions			
38.05	5.08	32.6	4.79
Return on total asset (Y)			
5.14	4.89	2.05	2.04
Percentage of stocks owned by management (X_1)			
20.16	25.57	21.65	24.05
Concentration ratio of the largest five stockholders (X_2)			
19.51	25.20	23.00	27.34
Revenue growth rate (X_3)			
48.33	37.06	12.06	7.55

As both the dependent and independent variables behave differently in terms of corporations' size, the estimation of step three (regression analysis by size) and the test in step four (test of homoscedasticity) should improve the results of step two (pooled multiple regression).

Regression results

Table 3 provides pooled multiple regression results of step two. The results indicate that:

1) Neither percentage of stocks owned by management (X_1), nor concentration ratio of the largest five stockholders (X_2) have any impact on profitability (Y) of high tech corporations;
2) Both percentage of stocks owned by management (X_1) and concentration ratio of the largest five stockholders (X_2) have significant and positive impact on profitability, (Y) of traditional corporations; and
3) Revenue growth rate (X_3) has a significant and positive impact on profitability (Y) of high tech as well as traditional corporations.

Table 3: Pooled multiple regression results (step two)

Dependent variable: Return on total asset (Y)

Independent variables: Percentage of stocks owned by management (X_1)
Concentration ratio of the largest five stockholders (X_2)
Revenue growth rate (X_3)

Intercept	X_1	X_2	X_3	R-square	Root MSE	Sample size
High tech corporations						
	2.794	0.019	0.038	0.32	2.927	101
	(4.133)*	(0.748)	(6.561)*			
	2.484	0.033	0.038	0.328	2.911	101
	(3.684)*	-1.302	(6.655)*			
Traditional corporations						
		0.074	0.014	0.364	2.938	298
		(11.786)*	(3.233)*			
		0.065	0.014	0.346	2.98	298
		(11.257)*	(3.164)*			

Numbers in parentheses are t-ratios.
* Significant at 1% probability level

Therefore, we can conclude from the results of step two that 1) agency problems of high tech corporations in Taiwan may not be tied to profitability; but 2) agency problems of traditional corporations in Taiwan may be associated with profitability; and 3) both high tech and traditional corporations would be more profitable if they were able to grow their revenue. More specifically, when traditional corporations have a higher percent of shares owned by their management, their profitability would also be higher.

Table 4: Multiple regression results by size (step three)
Dependent variable: Return on total asset (Y)
Independent variables:Percentage of stocks owned by management (X_1)
Concentration ratio of the largest five stockholders (X_2)
Revenue growth rate (X_3)

Intercept	X_1	X_2	X_3	R-square	Root MSE	Sample size
Large high tech corporations						
	2.980	0.021	0.032	0.424	2.508	43
	(3.731)*	(0.615)	(5.196)*			
	2.658	0.038	0.032	0.437	2.480	43
	(3.343)*	(1.124)	(5.272)*			
Small high tech corporations						
	2.586	0.012	0.050	0.285	3.220	57
	(2.378)*	(0.316)	(4.518)*			
	2.215	0.027	0.050	0.291	3.207	57
	(2.038)	(0.719)	(4.579)*			
Large traditional corporations						
		0.068	0.008	0.448	2.193	100
		(7.978)*	(1.703)			
		0.065	0.009	0.441	2.208	100
		(7.849)*	(1.636)			
Small traditional corporations						
		0.076	0.018	0.347	3.243	198
		(9.259)*	(2.894)*			
		0.065	0.018	0.323	3.300	198
		(8.725)*	(2.800)*			

Numbers in parentheses are t-ratios.
* Significant at 1% probability level

Table 4 presents multiple regression results by corporations' size of step three. The results indicate that:

1. Neither the percentage of stocks owned by management (X_1), nor the concentration ratio of the largest five stockholders (X_2) have an impact on profitability (Y) of large or small high tech enterprises;
2. Both the percentage of stocks owned by management (X_1) and the concentration ratio of the largest five stockholders (X_2) have significant and positive impacts on profitability (Y) of large and small traditional corporations;
3. Revenue growth rate (X_3) has a significant and positive impact on profitability (Y) of large and small high tech firms; and
4. Revenue growth rate (X_3) has a significant impact on profitability (Y) of small traditional corporations, but not on large traditional corporations.

Therefore, we can conclude from the results of step three that 1) the agency problem of large and/or small high tech corporations in Taiwan may not be tied to its profitability; 2) the agency problem of large and/or small traditional firms in Taiwan may be associated with its profitability; 3) both large and small high tech companies would be more profitable if they were able to grow their revenue; and 4) small traditional corporations would be more profitable if they were able to grow their revenue, but not for large traditional enterprises.

By comparing results of step two to that of step three, we can conclude that both small and large high tech corporations behaved similarly while large traditional corporations' profitability have been contained with limited potentials.

Test of homoscedasticity

The final (fourth) step of the study, estimates the "two sample variance F-statistics" to test the hypothesis that the mean square error (MSE) of the large size corporations equals the MSE of the small size businesses based on the results of step three. The results, as shown in Table 5, indicate that residual values of small traditional corporations behave differently from that of large traditional firms. Hence, the multiple regression results for traditional corporations in step two might not be efficient estimates and the coefficients of revenue growth rate (X_3) becomes insignificant for large traditional corporations in step three. Given the main objective of the study is to evaluate the impacts of ownership structure (X_1 and/or X_2) on a firm's profitability (Y), and results from steps two and three were generally consistent, our conclusion is not affected at all.

Table 5: F-test of homoscedasticity (H_o: $MSE_{large} = MSE_{small}$)		
	F_a	c (5% significant level)
Model 1:		
High tech corporations	1.648	1.690 (Fail to reject)
Traditional corporations	2.187	1.430 (Reject)
Model 2		
High tech corporations	1.672	1.690 (Fail to reject)
Traditional corporations	2.234	1.430 (Reject)

IMPLICATIONS

The results indicate that traditional corporations have significant agency problems while high tech enterprises have insignificant agency problems. As high tech corporations' profitability depends more on their new product development/technology innovations while traditional businesses depend more on their managerial skills and efficiency, investors may need to include ownership structure of traditional corporations and technology leading edge of high tech firms as critical factors to consider for stockholder wealth maximization.

The results also indicate that revenue growth rate is insignificantly associated with profitability for large traditional companies. Since the market for traditional corporations is generally deemed mature, opportunities for revenue growth, especially for large traditional corporations, could be limited at the expense of lower profitability.

Since agency problems behaved differently between high tech and traditional corporations, the results imply that the effect of separation of ownership and control on today's corporations could be significant or insignificant, pending on the nature of the industry in which the corporation operates. Future studies of agency problems and stockholders' profit maximization may consider including variables to reflect leading edge/technology innovations of high tech corporations. For example, a direct comparison of product model years and features among corporations may help create measurement to approximate technology level.

SUMMARY AND CONCLUSION

The main objectives of the paper are to: 1) estimate the effect of ownership structure on corporations' profitability of high tech and traditional corporations respectively; 2) compare agency problems between high tech and traditional corporations; and 3) provide implications for stockholders' wealth maximization.

The results indicate that 1) traditional corporation have significant agency problems while the agency problems for high tech corporations are insignificant; 2) the pooled regression model for traditional corporations violates the assumption of homoscedasticity because the residual values of small traditional corporations behave differently from those of large traditional corporations; 3) revenue growth rate is significantly and positively associated with profitability for both large and small high tech corporations; and 4) revenue growth rate is significantly and positively associated with profitability for small traditional corporations, but not for large traditional corporations.

By comparing high tech corporations to traditional corporations, we also conclude that agency problems behave differently among industries, i.e. the effect of separation of ownership and control on today's firms could be significant or insignificant, pending on the nature of that industry. The study helps investors who seek stockholders' wealth maximization and future research needs to consider including variables to reflect technological factor in studying agency problems of high tech corporations.

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GLOBALIZATION AND DEMOCRACY: *A GENERAL DISCUSSION*

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ABSTRACT

The question of whether or not globalization promotes democracy represents a longstanding debate. There are numerous arguments that can be made to endorse the idea that globalization promotes democracy. First, the technological innovations that arrive with globalization bring with them advances in communication that enable citizens to pass along information more freely, and this in turn helps to educate a society. Also, globalization helps the professional and middle classes grow. These two groups, in turn, assist the process of democratization.

It is also possible to argue against the theory that globalization promotes democracy. Many times due to globalization, authoritarian governments' control is prolonged by the economic prosperity that is experienced. The citizens associate the booming economy with the current form of government. At times during globalization, foreign companies will set up a manufacturing plant in another country. Soon that country's economy will experience a period of prosperity but will then become reliant upon that one plant. If that company decides to close the plant, the country's economy will be destroyed. Another argument against the theory that globalization promotes democracy is that it creates a large gap between the wealthy and the poor.

These arguments bring to light some concerns for a manager dealing in international business today. Profits cannot be a manager's only concern, especially when doing business with or in a foreign country. Companies must realize that when they are dealing with foreign companies, they are not only representing their company but also their country. It is of the utmost importance that the welfare of the community, its individuals, and the environment are taken into account.

INTRODUCTION

A number of factors impact the extent to which globalization does or does not promote democracy. The term globalization has existed for quite some time but has only become a popular buzzword in recent years. This is due in part to the economic and political changes that took place after the Cold War. The factors include – but are not limited to – interdependence, cultural, legal, political and economic alignments, and economic opportunities and competition. International disciplines are not a current phenomenon but rather a means for understanding our global society and the process of globalization. It has been debated whether globalization drives democracy, and critics have argued for both sides of the issue.

Globalization is “best thought of as a multi-dimensional phenomenon involving diverse domains of activity and interaction including economic, political, technological, military, legal, cultural, and environmental” (Held, 1997, 16). While the above is a basic definition of globalization, in actuality it is too complex to be summed up in a single sentence. Additionally, the significance of globalization differs for individuals, groups and countries (Held, 1997). This means that depending on which country you are dealing with, globalization can be more or less of a factor. For instance, among the cultural elites of the world, globalization is more of an influential factor when compared to a developing country. This is not to say that countries like Sudan and Ethiopia are unaffected by globalization, they just usually seem to have less of a stronghold on the actual forces involved. In other words, these countries are still influenced by globalization but often cannot control the forces (Held, 1997).

Democracy according to the contemporary definition is generally a type of government that “relies on elected representatives and tends to draw a distinction between the public and private spheres” (Walt, 2000, 38). Additionally, a number of elements seem to be common to all those societies that are known as democracies. These elements include elections, competition for public support, and the governing bodies’ accountability to the people (Walt, 2000). While the above terms do describe what we might call democratic concepts, a number of other factors differentiate democracies from other types of states. A democracy is a “system in which no one can choose himself, no one can invest himself with the power to rule and, therefore, no one can abrogate to himself unconditional and unlimited power” (Walt, 2000, 36). In a democratic system the voters who elected the officials into power hold rulers accountable.

This paper will discuss arguments both for and against globalization powering democracy. At the end, we will share our thoughts on the issue as well as discuss the impact this has on the role of a manager in business today.

LITERATURE REVIEW

Opposing thoughts

Benjamin Barber speaks of two controversial “schools of thought” in his article entitled “Jihad vs. McWorld.” Jihad relates to hundreds of narrowly conceived faiths against every kind of interdependence, every kind of artificial social cooperation and civic mutuality. In other words, Jihad is against globalization and therefore democracy as well.

On the other hand, McWorld refers to the onrush of economic and political forces that demand integration and uniformity. These forces mesmerize the world with fast music, fast computers, and fast food. The momentum of these forces press nations into one commercially homogeneous global network tied together by technology, ecology, communications, and commerce. These two forces operate with equal strengths but in opposing directions. Jihad is driven by parochial hatreds, and McWorld is powered by globalization and integrating people and economies (Soe, 2001).

McWorld is primarily driven by four factors. These include a market imperative, a resource imperative, an information-technology imperative and an ecological imperative. Essentially, these forces are responsible for shrinking the world and diminishing national borders.

A market imperative gives a good link to how democracy drives globalization. Many international organizations are created for the promotion of trade. It is not coincidental that a majority of these are run by democratic ideals. Common organizations and markets demand a common currency, language, and the like. The Western model of democracy has proven to be strong when compared to alternative political institutions. Resource and information-technology imperatives are essential to the concept of globalization. Humans, by nature, are dependent on each other. This way of living promotes interdependence by providing a medium for exchange. McWorld, or globalization, is a primary driver of democracy in many respects. It serves as a sanctuary for people of all ethnic and national backgrounds.

According to the stakeholder theory, written by R. Edward Freeman, the stockholders in a company are far from the only people who should be of concern to management. Freeman states that the interests of everyone, from the top-level executives to members of the surrounding community, must be taken into account (Freeman, 1999, 479). This sounds good in theory, but how does one enforce such an idealistic notion? Today's managers are faced with a very difficult situation in the world economy. They must provide high returns for their shareholders.

In the work of David Held (1997), the discussion of cosmopolitan democracy came up. Cosmopolitan democracy involves the development of administrative capacity and independent political resources at regional and global levels as a necessary complement to those in local and national polities. The theory of cosmopolitan democracy sets out to accomplish a number of goals, which include an establishment of a global parliament, separation of political and economic interests, an interconnected global and legal system that deals with both criminal and civil law, and decreasing the ability of nation-states to coerce the regional and global institutions in power (Held, 1997). Also mentioned in Held's theory was the creation of an effective, accountable, international military force that would enforce the rules and regulations set forth by the governing organization (Held, 1997). We believe that cosmopolitan democracy stands above other alternatives as the best means for insuring that globalization does promote democracy in a positive manner.

Karl Marx believed that workers would unite under Communism on an international level. Since Communism failed as a political system, a system like democracy based more on individuality is highly unlikely to spread. However, some of the social and economic ideas of Karl Marx that dealt with fairness were incorporated into capitalism.

Globalization, if followed by democracy, will create unequal social classes that will ultimately revolt. Political scientists concur that political institutions and economic institutions are inherited from the past. This provides strong framework for shooting down the theory that democracy follows in the footsteps of globalization. As yet it is hard to determine whether one promotes or needs democracy. There is much to be said about both sides, and many conclusions to be drawn.

Globalization drives democracy

For the last quarter of a century, globalization has become a major theme all over the world. Globalization is "driven by common values of freedom, democracy and the desire to share what the world has to offer" (Maiello, 2001, 60). Whether you are living in a developed or a developing country, globalization has played a role in your nation's operations. Traditionally, stronger countries imposed their preferences on the weaker ones. Our world is changing due to globalization; the world is more connected, more intensive and extensive than ever before (Held, 1997). Over the past few decades we have seen a rise in the number of democratic states throughout the world (Zakaria 2003).

In the early 20th century, very few countries were democratic. In 1974 only 39 countries were democratic. By 1996, 66% of countries had made a transition to a democratic political system (Schwartzman, 1998). Countries tended to make this transition in "clusters." It began in parts of Asia, Europe and Africa during the 1970's. South Korea, Taiwan, South Africa, and most of Eastern Europe followed one another in adapting a democratic political system. Soon after in the 1980's, some Latin American countries made similar transitions toward becoming democratic states.

According to Fukuyama, "the human need for globalization leads to the perfect political form, democracy." (Schwartzman, 1998, 160). In other words, globalization acts as a catalyst for democracy in a number of different ways. It takes on different roles in order to achieve this. There are four main reasons that support this statement: 1) Technological innovations in communication and transportation accompany globalization. 2) Globalization brings with it the growth of the professional and middle class, the main carriers of democracy. 3) Globalization brings with it the growth of the working classes, who are the main agents of democracy. 4) Globalization undermines non-democratic states (Schwartzman, 1998). In the short run, the middle class and educated people are the engine of globalization. The future of globalization depends upon the distribution of income and wealth for majority of the world's population.

Technological innovations in communication and transportation that accompany globalization help to spread democracy to other countries. A definition provided by David Held can help to clarify this concept. He defines globalization as a "spatial phenomenon." He goes on to say that it "involves a stretching and deepening of social relations and institutions across space and time such that, on the one hand, day to day activities are increasingly influenced by events happening on the other side of the globe and, on the other hand, the practices and decisions of local groups or communities can have significant global reverberations" (Held, 1997, 14). As the speed of global communication has grown, it is impossible to keep events confined to one nation. New technologies such as e-mail, fax machines, wireless communications, and the Internet make it easy for people to communicate quickly and efficiently all over the globe. Improvements in communication make it easier for people to coordinate actions and ideas across national borders.

Due to new and readily available technology, the rate of globalization has increased. Technology has been credited with being an engine for democracy (Barber, 2001, 43). These technological advances have been shown to undermine socialism and contribute to democratization because they increase the ability of ordinary people to bring about social movements (Schwartzman, 1998).

Some examples of these types of actions include the following: 1989 Tiananmen Square demonstrations, where Chinese demonstrators used fax machines to communicate with the outside world (Dalpino, 2001). Another salient example of this is the 1998 anti-Suharto resistance in Indonesia that was "largely directed via the Internet" (Dalpino, 2001, 47). There are other examples that cell phone has been used as a means of communication (e.g., Iran). It is clear that we live in an interconnected society where technology is king. Additionally this influx of technology seems to be inevitable. Countries like North Korea and some Middle Eastern countries have been able to ward off technological progress in the short-term, but in the long run there is little they can do to remain technologically isolated (Petras, 1999).

Globalization can lead to the increased opportunity for people to obtain jobs and earn money. The Maquiladores in Mexico provide an example of this increased opportunity. As companies expand their business into Mexico, some local Mexicans have been provided with jobs. In turn, this has allowed them, as a society, to build schools to educate their children.

This type of globalization is happening in many other parts of the world. With the positive effects of globalization helping to stimulate the economy, many people have the chance to educate themselves and the members of their society. In turn, literacy rates and education levels have risen all over the world. An increase in a society's level of education has a tendency to pave the way for characteristics of trust, satisfaction and competence, which are all ideas that relate to democracy (Radice, 2000).

The fourth supporting argument states that globalization makes it virtually impossible for authoritarian regimes and non-democratic states to regulate and integrate their economies. For example, in the former Soviet Union, the government controlled all aspects of the market. Corporations did not have the freedom to trade on their own. This was because of the high levels of regulation placed on them by their government.

On the contrary, the U.S. practices a capitalist style of government. Businesses are free to compete and trade in both the domestic and international markets with comparatively little government regulation. As production becomes more reliant on technology and capital moves quickly around the world, the role of national governments is limited (Schwartzman, 1998). With the progression of the forces of globalization, economies are becoming more diverse. The more diverse an economy is, the more difficult it is for authoritarian regimes to take control, making a democracy the desired state. Also, development of larger number of non-government organization would help to create and sustain the democracy.

Aside from the above mentioned arguments that globalization promotes the spread of democracy, there are a few other points that help support this theory. Throughout history we have seen how stronger countries can impose their ideals on weaker ones. Democracy has been the favored political system in the U.S. Due to the success that our nation has experienced, other nations have looked to democracy as their ticket to similar achievements.

Case study: South Korea

South Korea provides us with a good example of globalization promoting a political change to a democratic state. During 1970-1980s South Korea made a transitional toward political democracy from military authoritarianism (Chung, 1999). This political transformation and institutional change was spurred by rapid economic and social changes, which started in the late 1960's. South Korea's economic growth from the 1960's to 1990s was one of the fastest in the world. With the issuance of a new economic development plan, South Korea's GNP expanded significantly and the growth has continued at different rate since then. In fact, their rapidly growing economy was thought by many experts to be a model for all developing nations. South Koreans who were once primarily farmers had changed to a nation of city dwellers with strong middle-class aspirations.

As these classes grew, they became more concerned and involved in their political state of the nation. This is a typical scenario with a rise in the level of education. Concerns such as social equality promoted active political participation and made the current authoritarian regime impossible to maintain. Factors such as the desire for economic freedom and the size and complexity of the economy called for a democratic political system. The political conversion that occurred in 1987 was not as quick as the economic changes.

Globalization does not promote democracy

It has been said that America's global culture is not hostile or socialist, but it is indifferent to democracy (Barber, 1998). What is meant by this indifference is that the American McWorld culture fails to take into account aspects of different cultures and is only concerned with finding consumers. In finding consumers, the local culture is in a sense stripped away, leaving only a French speaking Mickey Mouse, or a McDonald's that serves beer. This is not democracy because, as we discussed before, democracy involves choices and the citizens making decisions. One of the most frightening aspects of this globalization trend is that “organizations such as the IMF, the World Bank, and the WTO, as well as few transnational elites, prescribe and dictate fiscal and monetary…policies to poor and less developed counties in a way that negates democracy” (Farazmand, 1999, 515). The people in these nations are not free to determine their own policies and have little or no say in what goes on from a political and economic standpoint.

While the intentions of the above-mentioned organizations and institutions are good, the end result is often poverty, social disintegration and environmental destruction. In 1994, the World Bank had sought to "provide $200 billion to the Third World in the next decade to promote the private sector" (Farazmand, 1999, 510). International loans such as this deepen the financial, military, political, and economic dependency on Western powers and globalizing powers, which can easily dictate policy choices to poor- and less-developed nations. This certainly is not what the democratic way is all about.

Globalization can often give the upper hand to authoritarian regimes because in the short term the conditions in the country improve, and it seems to the populace that promises have been delivered (Dalpino, 2001). The irony of all this is that the longevity of the authoritarian regime is often extended through the assistance from companies in supposedly democratic nations. The truth of the matter is that while the countries where these companies are based are democratic, the policies of capitalism are inherently antidemocratic. “Exporting democracy” has been a favorite slogan under this new wave of globalization, but the “record shows that the great capitalist democracies of the west, including the United States, have supported some of the most repressive and exploitive dictatorships around the globe” (Farazmand, 1999, 511).

An example of this link between globalization and authoritarian advantage can been seen in the Asian economic crisis of 1997-98. “Vietnam and Laos, which had begun very modest political reforms to accompany marketization, jettisoned these political moves when their trade with the countries hit hardest by the crisis declined” (Dalpino, 2001, 47). In the above-mentioned region, the fastest growing economies failed because of their close link to Western democracies; quickly the reformed governments were replaced with the old authoritarian regimes (Thorton, 1999).

It was thought that the push for globalization would improve economic conditions by creating a new middle class that would in turn bring democratic influence. In actuality, the opposite took place. There is some truth to this generalization, but what is not mentioned is that a class of social elites tends to come about as well (Nye, 2001). For example, Chile has been touted as a model of privatized economy, when in fact one-third of the population lives in poverty, while the military-bureaucratic business elite enjoy world-class lifestyles (Farazmand, 1999).

PepsiCo has been operating in Burma since 1991. They entered into a joint venture with Myanmar Golden Star Co., a Burmese company. This venture set up a bottling plant with a 10-year license to bottle and distribute PepsiCo products in Burma. This business deal had very successful results. In 1995, PepsiCo reported that the revenues made by the Burmese bottler totaled $20 million, of which PepsiCo's share was $8 million. In 1996, their revenues increased by 25 percent (Velasquez, 1998).

What we must examine more closely is the situation in Burma, during the last decade and today. In September 1988, the army under General U. Saw Maung assumed control and brutally repressed dissent, killing thousands of students and civilians. General Maung replaced the government with a group of military officers named the State Law and Order Restoration Council (SLORC). This authoritarian regime was in need of private investors and companies to provide funding in Burma in the hopes of improving the economy. PepsiCo was one of the many companies that responded. This move was solely for economic reasons. Labor was cheap, but literacy was extremely high because of Burma's high cultural value placed on education.

The impact of PepsiCo's move into Burma had some underlying ethical and undemocratic ideals. The case discussed here proves that globalization does not drive democracy. Rather, the reverse is a more suitable assumption.

Velasquez (1998) stated that "The government's unacceptable record on human rights changed little in Burma. Burmese citizens continued to live subjected at any time and without appeal to the arbitrary and sometimes brutal dictates of the military." (164) Furthermore, millions of Burmese citizens were forced to work under harsh conditions. Also, the SLORC continued to restrict basic rights to free speech, association, and assembly. All these actions are clearly undemocratic by any sense of a legitimate state democracy.

Many have claimed that by doing business in Burma, PepsiCo was helping to prop up the repressive military government through tax income and other sources. By leaving Burma, PepsiCo and other global companies would force the military to fail in its attempts to create a vibrant economy. The trickle down effect of this concept is very intuitive. The declining economic conditions would pressure the military into instituting democratic reforms to attract foreign investment back into the country.

A common slogan that PepsiCo promoted was, "Free trade leads to free societies." Apparently the opposite was true. PepsiCo's stockholders' did not want the company involved in Burma, and a majority of their consumers boycotted their products. As a result of stockholder and consumer dissatisfaction, PepsiCo was forced to abandon the Burma venture.

Burma's repressive, authoritarian government survived on global investments by PepsiCo, other companies, and private investors which is common. In many states of today and the past, authoritarian regimes have milked foreign investors and companies. Hence, globalization does not always promote democracy.

DISCUSSION AND SOME CONCLUSIONS

There is not a definitive model that fits the arguments discussed above. Merely, what we have are many generalizations supported by some facts, details, and cases. There are two opposing "schools of thought." One being that globalization promotes democracy. Opponents feel that globalization inhibits and refutes democratic ideals.

Globalization expedites the process of transferring information, funds, and ideas. With this in mind, proponents believe that democracy is spread and absorbed by different cultures. Winston Churchill once said that "democracy is the worst form of government until you compare it to its alternatives." Supporters feel that globalization will spread democratic ideals to many parts of the world. Opponents take the other side of this issue. The case of PepsiCoBurma shows globalization defeating democracy. An authoritarian regime was supported by a corporation from a democratic state.

There are many possible "answers" to this question of the relationship of globalization to democracy, but not one single definitive one. If there were a clear-cut answer, the discussion of this topic would be much more straightforward and not geared for an analytical paper such as this. There are positives and negatives to globalization, and in many cases, globalization does promote democracy. While this is all well and good, there are other things that need to be taken into consideration, such as who really benefits from these business ventures? What happens when they go wrong? Finally, who is in charge on a global scale?

MANAGERIAL IMPLICATIONS

A manager in the 21st century has to take many things into consideration with regard to the topic of globalization and its effect on the spread of democracy. The most obvious concerns revolve around the ethical implications of operating a business in a foreign nation (particularly in a developing country). The manager of today must ask himself or herself why they are expanding or relocating their operations into another country. If the answer to that question is "purely profit," then the motivations of the corporation are possibly inappropriate.

It is important to take into consideration the needs, wants and desires of the stockholders, but along the same lines there are other parties involved. Those parties include the members of the local community, the employees' themselves, and even the customers. It has been said by R. Edward Freeman that if the needs of all the stakeholders (not just stockholders) are not taken into proper consideration, then the company is not operating in an ethical manner. Freeman also seems to think a company that meets the needs of all of its stakeholders will be more successful than a company motivated only to turn a profit for its stockholders.

CONCLUSION

We have analyzed a two-sided model in this paper. The first side relates to the extent that globalization promotes democracy. The second, or opposite side, is the extent to which globalization hinders democracy.

We have viewed these topics through perspectives of others, cases, facts and opinions to draw some conclusions. The question that can be posed is: Does globalization promote democracy? The answers to this question seems to be inconclusive. We agree that globalization does play a role in the spread of democracy, but the question remains: To what extent is this positive and how much the citizens of a developing country are involved and receive the benefits. A possible extension of this study might include a statistical analysis of the spread of democracy and the success factors that allow developing nations to overthrow authoritarian regimes. Also, the ethical implications of this topic could be an interesting direction of study.

ENDNOTE

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SUGGESTED COMPETITIVE STRATEGIES AND A FIRM'S LABOR PRODUCTIVITY IN GLOBAL MARKETS: AN EMPIRICAL INVESTIGATION

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ABSTRACT

This pioneer study explores and investigates the relationship between five competitive strategies and a firm's labor productivity in global markets. The findings of this study reveal that four strategies (adapt to local market differences, exploit economies of global scale, tap optimal locations for activities and resources, and maximize knowledge transfer across locations) have positive and significant relationships with a firm's labor productivity. The fifth strategy (exploit economies of global scope) has a marginal relationship with labor productivity.

INTRODUCTION

Globablization refers to the process of increasing social and cultural inter-connectedness; political interdependence, and economic, financial and market integrations (Eden and Lenway, 2001; Molle, 2002; Orozco, 2002). Globalization has caused dramatic changes in business around the world (Thourmrungroje, 2004; Mazur, 2004). The effects of globalization are far more pervasive, affecting every individual, business, industry, and country (Gilpin, 2000). The semiconductor industry provides a prime example. A recent Industry Week analysis indicated that nearly 60 percent of the revenues for computer and other electronic manufacturers in the United States came from outside of North America. The real benefit of globalization came from outside of the direct interaction with customers in the markets they serve (Conrad, 2004).

However, a global presence in global markets by itself does not guarantee global competitive advantages (Gupta and Govindarajan, 2001). For example, PepsiCo, Inc. had built an extensive and wide-ranging global presence by the mid-1990s. It increased its investments in international soft drinks from $1.5 billion in 1990 to $5.0 billion in 1995. Yet, PepsiCo's global expansion did not generate growth and profitability. Pepsi withdrew from some major markets in 1997, and took about a $1.0 billion loss from international markets. This situation contrasted significantly with the aggressively growing Coca-Cola (Tomkins, 1997).

Gupta and Govindarajan (2001) concluded that PepsiCo's experience suggests that securing a global presence is anything but synonymous with possessing global competitive advantage. Although building a global presence gives the firm the opportunity to play the game, it does not reveal much about whether and how a firm can actually win the game. Holtbrugge (2004) claimed that even winning one game does not ensure that the firm will win the next one. Therefore, global presence must be converted into global competitive advantage. However, transforming global presence into global competitive advantage requires systematic analysis, purposeful thinking, careful orchestration, and is a never-ending process. Without a strongly disciplined approach, global presence can easily turn into a liability that distracts management and wastes resources. The end result can even lead to a loss of the firm's competitive advantage in its domestic market.

This pioneer study investigates the relationship between suggested competitive strategies (adapt to local market differences, exploit economies of global scale, exploit economies of global scope, tap optimal locations for activities and resources, and maximize knowledge transfer across locations) and a firm's labor productivity.

SUGGESTED COMPETITIVE STRATEGIES

Building on the previous work of several scholars (e.g., Caves, 1982; Ghoshal, 1987; Porter, 1994a), Gupta and Govindarajan (2001) suggested several competitive strategies that will help a firm convert its global presence into global competitive advantage and generate benefits from the implementation of these strategies. These strategies include adapting to local market differences, exploiting economies of global scale, exploiting economies of global scope, tapping the optimal locations for activities and resources, and maximizing knowledge transfer across locations.

Adapt to Local Market Differences

A direct implication of being present in multiple countries is that companies must respond to the inevitable heterogeneity they will encounter in these markets. Differences in language, culture, income levels, customer preferences, and distribution systems are only some of the factors to be considered. Even in the case of apparently standard products, at least some degree of local adaptation is often necessary, or at least advisable (Gupta and Govindarajan, 2001).

For example, cellular phone manufacturers must adapt their products to different languages and the magnitude of background noise on the street. By responding to country-level heterogeneity through local adaptation of products, services and processes, a company can reap benefits in three fundamental areas: market share, price realization, and competitive position (Root, 1994).

(a) Increased market share. Usually, offering standard products and services across countries reduces the boundaries of the served market to only those customers whose needs are uniform across countries. Local adaptation of products and services has the opposite effect, expanding boundaries to also include those customers within a country who value different features and attributes. For example, McGraw-Hill Companies' Business Week magazine illustrates how local adaptation of products and services can enlarge the customer base.

As the magazine's editor-in-chief explained: Each week, we produce three editions. For example, this week's North American cover story is "The New Hucksterism." The Asian edition cover is "Taiwan's Global Powerhouse." And, the European edition cover is "Central Europe." In addition, their writers create additional stories customized for readers in Europe, Asia, and Latin America. They also turn out four pages of international finance coverage, international editorials, economic analysis, and a regional feature column (Business Week, 1996).

(b) Improved price realization. Tailoring products and services to the preferences of local customers (e.g., Baskin-Robbins's introduction of green-tea flavored ice cream in Japan) enhances the value delivered to them. As a corollary, a portion of this increased value should translate into higher price realization for the firm (Root, 1994).

(c) Neutralizing local competitors. One of the natural advantages enjoyed by most local competitors stems from their deep understanding of, and single-minded responsiveness to, the needs of the local market. For example, in the Japanese soft-drinks market, Suntory Ltd. and Asahi Soft Drinks Co. have been among the first to offer new concepts such as Asian teas and fermented-milk drinks. When a global player customizes its products and services to local needs and preferences, it is mounting a frontal attack on the local competitors in their market niche.

In its efforts to neutralize Suntory's and Asahi's moves and attack them on their home turf, Coca-Cola introduced several new products in Japan that are not offered by the company in other markets. These products include an Asian tea called Sokenbicha, an English tea called Kochakaden, and a coffee drink called Georgia (Wall Street Journal, 1997).

Exploit Economies of Global Scale

Building global presence automatically expands a company's scale of operations, giving it larger revenues and a larger asset base. However, larger scale will create competitive advantage only if the company systematically undertakes the tough actions needed to convert scale into economies of scale. Potential benefits of economies of scale can appear in various ways: spreading fixed costs, reducing capital and operating costs, pooling purchasing power, and creating critical mass (Chandler, 1990).

(a) Spreading fixed costs over larger volume. This benefit is most salient in areas such as research and development, operations, and advertising. For instance, Merck, the pharmaceutical

giant, can spread R&D costs over its global sales volume thereby reducing per-unit costs of development. Such reduction in unit cost would give Merck competitive advantage.

(b) Reducing capital and operating costs per unit. This benefit is often a consequence of the fact that doubling the capacity of a production facility typically increases the cost of building and operating the facility by a factor of less than two.

(c) Pooling global purchasing power over suppliers. Concentrating on global purchasing power over any specific supplier generally leads to volume discounts and lower transaction costs. For example, as Marriott has raised its stakes in the global lodging business, its purchase of such goods as furnishings, linens, and beverages has stepped up dramatically. Exercising global purchasing power over a few vendors (e.g., PepsiCo for soft drinks) is part of Marriott's efforts to convert its global presence into global competitive advantage.

(d) Creating requisite critical mass in selected activities. A larger scale gives the global player the opportunity to build centers of excellence for the development of specific technologies and/or products. To develop a center of excellence, a company generally needs to focus a critical mass of talent in one location. In view of the potential to leverage the output of such a center on a global scale, a global player will be more willing and able to make the necessary resource commitments required for such a center (Chandler, 1990).

Exploit Economies of Global Scope

Global scope refers to the multiplicity of regions and countries in which a company markets its products and services. Consider the case of two hypothetical advertising agencies, Alpha and Beta, whose sales and revenues are roughly comparable. Assume that Alpha offers services in only five countries, whereas Beta is in 25 countries. In this instance, we would consider the global scope of Beta to be broader than that of Alpha. Global scope is rarely a strategic imperative when vendors are serving customers who operate in just one country or customers who are global but who engage in centralized sourcing.

In contrast, the economic value of global scope can be enormous when vendors are serving customers who, despite being global, need the delivery of identical or similar products and services across many markets. In fulfilling the needs of such multi-location global customers, companies have two potential avenues through which to turn global scope into global competitive advantage: providing coordinated services and leveraging their market power (Malnight, 1994).

(a) Providing coordinated services to global customers. Consider three scenarios: Microsoft, as it launches a new software product in more than 50 countries on the same day and needs to source advertising services in every one of the targeted markets; McDonald's, which must source virtually identical ketchup and mustard pouches for its operations in every market; and Shell Oil, which needs to source similar process-control equipment for its many refineries around the world.

In all of these examples, a global customer needs to purchase a bundle of identical or similar products and services either from a host of local suppliers or from a single global supplier that is present in all of its markets. Compared with a horde of local suppliers, a single global supplier can provide value for the global customer through greater consistency in the quality and features of products and services across countries, faster and smoother coordination across countries, and lower transaction costs (Malnight, 1994).

(b) Market power compared with competitors. A global supplier has the opportunity to understand the unique strategic requirements and culture of its global customer. Since it takes time to build this type of customer-specific proprietary knowledge, particularly in the case of multi-location global customers, potential competitors are initially handicapped.

For example, Federal Express, a major supplier of logistics and distribution services to Laura Ashley, currently enjoys this advantage. As a global logistics provider, FedEx has had the chance to deepen its understanding of its role in Laura Ashley's value chain in all of its served markets. Such understanding is customer-specific and takes time to build. As long as Federal Express continues to provide effective and efficient logistics services to Laura Ashley, this knowledge will serve as a major entry barrier for other local or global logistics suppliers (Malnight, 1994).

Tap Optimal Locations for Activities and Resources

Even though global economies have become increasingly integrated and influenced by the media so that cultures take on many of the same aspects, most countries will continue to be largely heterogeneous for years to come. Inter-country heterogeneity has an impact on the need for local adaptation in a company's products and services. But differences across countries also reveal themselves in the form of differences in cost structures and skill levels. A firm that can exploit these inter-country differences better than its competitors has the potential to create significant proprietary advantage (Dunning, 1998; Porter, 1994b).

In performing the various activities along its value chain (e.g., R&D procurement, component manufacturing, assembly, marketing, sales, distribution, and service), every firm has to make a number of crucial decisions, including where the activity will take place. Optimizing the location for every activity in the value chain can yield one or more of three strategic benefits: performance enhancement, cost reduction, and risk reduction (Dunning, 1998; Porter, 1994b).

(a) Performance enhancement. Fiat's decision to choose Brazil, rather than its native Italy, to design and launch the Palio, its world car, and Microsoft's decision to establish a corporate research laboratory in Cambridge, U.K., are good examples of location decisions that were guided predominantly by the goal of building and sustaining world-class excellence in the selected activities. Location decisions can affect the quality with which any activity is performed in terms of availability of needed talent, speed of learning, and the quality of external and internal coordination (Dunning, 1998; Porter, 1994b).

(b) Cost reduction. One example of a location decision founded predominantly on cost-reduction considerations is Nike's decision to source the manufacture of athletic shoes to Asian countries such as China, Vietnam, and Indonesia. Another is the decision of Texas Instruments to set up a software development unit in India. Location decisions can affect the cost structure in terms of the cost of manpower and other resources, the cost of transportation and logistics, as well as government incentives (Globerman and Shapiro, 1999) and the local tax structure (Dunne and Rollins, 1992).

(c) Risk reduction. Given the wild swings in exchange ratios between the U.S. dollar and the Japanese yen (in relation to each other as well as to other major currencies), a critical basis for cost competition between Ford and Toyota has been their relative ingenuity at managing currency risks (Miller and Reuer, 1998).

Maximize Knowledge Transfer Across Locations

Foreign subsidiaries can be viewed from several perspectives. One way to view Marriott's subsidiary in the U.K. is in terms of its market position with the United Kingdom's hotel industry. An alternate view of United Kingdom's Marriott would be as a package of tangible assets such as buildings, equipment, and capital. Yet another view would be to see Marriott U.K. as a reservoir of knowledge in areas such as real estate development, revenue management, hotel operations, and customer service. Building on this last perspective, we can view every global company not only as a portfolio of subsidiaries with tangible assets, but also as a portfolio of knowledge centers (Gupta and Govindarajan, 1991; Nobel and Birkinshaw, 1998).

Given the heterogeneity of countries, every subsidiary has to create some degree of unique knowledge to exploit the resource and market opportunities of the local environment. For example, the ability to execute advertising in the Japanese language has little or no value outside Japan. However, other types of locally created knowledge may be relevant across multiple countries. If such knowledge is leveraged effectively, it can yield strategic benefits to the global enterprise, ranging from faster product and process innovation to lower cost of innovation and reduced risk of competitive preemption (Gupta and Govindarajan, 2001; Nobel and Birkinshaw, 1998).

(a) Faster product and process innovation. All innovation requires the incorporation of new ideas, whether they are developed internally or acquired and absorbed from others. A global company's skill at transferring knowledge across subsidiaries gives these subsidiaries the added benefit of innovations created by their peers. Procter and Gamble's highly successful launch of Liquid Tide in the U.S. market in the late 1980s occurred, at least partly, because the development of this product incorporated technologies pioneered in Cincinnati (Ingrassia, 1985).

(b) Lower cost of innovation. A second by-product of not reinventing the wheel is considerable savings in the costs of innovation. For example, the efficient stocklist-based distribution system developed by Richardson Vicks' Indian operation, now a part of Procter and

Gamble India, found ready applicability in the company's Indonesian and Chinese operations. Such cross-border replication of an innovation from one country to another eliminates the costs associated with from-the-ground-up experimentation, or at least significantly reduces the cost in that country (Gurcharan, 1993).

(c) Reduced risk of competitive preemption. A global company demands constant innovations from its subsidiaries. If such global company does not leverage these innovations effectively across subsidiaries, risks become a fount of new ideas for competitors. Procter and Gamble (P&G) is keenly aware of these risks. Several of P&G's subsidiaries are dedicated to improving the fit, performance, and look of the disposable diaper.

Over the last decade, P&G's ability to systematically identify the successful innovations and expedite a global rollout of these innovations has thwarted competitors from stealing its new ideas and replicating them in other markets. Effective and efficient transfer of knowledge across subsidiaries has also helped P&G safeguard its innovations and enabled it to significantly reduce the risk of competitive preemption (Gurcharan, 1993).

LABOR PRODUCTIVITY

At a general level, labor productivity is defined as total output divided by labor inputs (Samuelson and Nordhaus, 1989). We focused on labor productivity for a number of reasons. First, labor productivity is a crucial organizational outcome; it indicates the extent to which a firm's labor force is efficiently creating output. Second, labor productivity is directly related to the firm's labor force. The face validity of this measure of firm success is also relatively high (Dyer and Reeves, 1995). Third, theorists of strategic human resource management have identified labor productivity as the crucial indicator of workforce performance (Delery and Shaw, 2001). Fourth, productivity has been the most frequently used outcome variable in a large body of work in the strategic human resource management literature (Boselie and Dietz, 2003).

However, this measure is not without limitations. First, it does not control for potential increases in costs (e.g., labor costs) that may accompany increased revenue generation. Second, not all elements of this outcome measure are directly controllable by employees (e.g., market, demand, product price). Because these limitations are not serious issues, this measure of productivity is a key indicator of the efficiency with which firms produce revenue; and it allows comparability across industries and with previous studies (Datta, Guthrie and Wright, 2005).

PURPOSE AND RESEARCH HYPOTHESES

The purpose of this study is to explore and examine the relationship between the five competitive strategies and the firm's labor productivity. Based on this objective, the following hypotheses have been formulated:

H_1: There is a significant and positive relationship between "adapt to local market differences" and the firm's labor productivity in global markets.

H_2: There is a significant and positive relationship between "exploit economies of global scale" and the firm's labor productivity in global markets.

H_3: There is a significant and positive relationship between "exploit economies of global scope" and the firm's labor productivity in global markets.

H_4: There is a significant and positive relationship between "tap optimal locations for activities and resources" and the firm's labor productivity in global markets.

H_5: There is a significant and positive relationship between "maximizing knowledge transfer across locations" and the firm's labor productivity in global markets.

RESEARCH METHODS

Research methods used in this study included survey questionnaire, sample and data collection, measurements, and statistical techniques. In addition, inter-rater reliability and biased responses were tested. Finally, the responding sample was investigated to determine whether it represented its target population.

Survey Questionnaire

To test the formulated hypotheses, a combination of primary and secondary data was utilized. Primary data concerning the five competitive strategies were obtained through a mail survey questionnaire. The researchers of this study adapted the mail survey questionnaire and its twenty statements from Gupta and Govindarajan's (2001) study. These statements were categorized under five competitive strategies as follows: adapt to local market differences (four items), exploit economies of global scale (four items), exploit economies of global scope (two items), tap optimal locations for activities and resources (three items), and maximize knowledge transfer across locations (seven items). Each statement had a five-point Likert response format ranging from strongly disagree (1) to strongly agree (5). Cronbach alpha obtained for the overall scale scores measuring the management practices ranged between 72 and 88 percent.

This survey questionnaire elicited opinions from the participating CEOs of multinational corporations (MNCs) about the five competitive strategies developed by Gupta and Govindarajan (2001). The surveyed CEOs were requested to assign the degree or the extent of their agreement or disagreement with each of the twenty statements categorized under the five competitive strategies.

The validity and reliability of the questionnaire was tested. Confirmatory factor analysis (CFA) was conducted to test the construct validity of the survey questionnaire items. To evaluate the fit of CFA, several goodness-of-fit indicators were used including X^2, goodness-of-fit index, and the root mean square residual (Merrilees and Miller, 2001). These constructs were analyzed individually to determine their unidimensionality.

A common approach to measuring reliability is Cronbach coefficient alpha. According to Kassim (2001), a reliability coefficient of around 90 percent can be considered excellent, values around 80 percent are very good, and values around 70 percent are adequate depending on the questionnaire items. Data analysis presented in the Appendix suggests that the survey questionnaire is valid and reliable.

Sample and Data Collection

The research sample consisted of 500 CEOs randomly selected from MNCs throughout the United States from the COMPUSTAT. The sample was derived from a research project covering several issues concerning global competitiveness in the 21st century. CEOs of the participating MNCs were mailed a cover letter requesting their participation, the survey questionnaire, a stamped return envelope, and a brief summary for the five strategies suggested in this study. Of the 500 mailed questionnaires, 131 (26.3 percent) were completed and returned. Secondary data concerning labor productivity, firm size, sales growth, and capital intensity were obtained from COMPUSTAT.

Measurement of Variables

Measurements included the five competitive strategies (independent variables), the firm's labor productivity (the dependent variable), and three control variables (firm's size, sales growth, and capital intensity).

(a) Competitive strategies. As mentioned, the five competitive strategies were measured by the survey questionnaire developed by the researchers of this study based on the work of Gupta and Govindarajan (2001).

(b) Labor productivity. Drawing on prior research (e.g., Guthrie, 2001; Huselid, 1995; Koch and McGrath, 1996), labor productivity was measured by the logarithm of the ratio of a firm's sales to its number of employees. Data were obtained from COMPUSTAT.

(c) Control variables. Control variables that have potential impact on a firm's labor productivity are the firm's size, firm's sales growth, and firm's capital intensity (Datta, Guthrie and Wright, 2005). The firm's size was controlled because it may be associated with the use of more sophisticated human resource practices as well as with higher productivity (Guthrie, 2001). Firm's size was measured by the natural logarithm of a firm's number of employees (e.g., Huselid, 1995; Koch and McGrath, 1996). Firm's sales growth was controlled because of its potential implications for a firm's productivity (Huselid, 1995). Firm's sales growth was measured by the average of growth in a firm's sales over a three-year period (2000-2003). Finally, the firm's capital intensity was controlled because of its possible relationship with use of high performance work systems and

firm productivity (Huselid, 1995; Koch and McGrath, 1996). Firm's relative capital intensity was computed as the mean of firm's capital intensity (fixed assets/sales) divided by the capital intensity for the particular firm's industry (Datta, Guthrie and Wright, 2005).

Statistical Analysis

Statistical analysis in this study utilized the Statistical Package for Social Science (SPSS-X) to compute frequencies and percentages. The AMOS package was utilized to conduct confirmatory factor analysis (CFA) to test the construct validity of the survey questionnaire; that is, to determine whether the scales of the twenty items measured distinct constructs.

DATA ANALYSIS

To determine the reliability of the survey-based measures, we applied the procedure of Kumar, Stern and Anderson (1993). Fifty second-senior executives were randomly selected from the responding firms and were also surveyed. A similar number was randomly selected from the responding CEOs. Responses for the two groups of executives (most senior and second senior executives) were then correlated to establish the inter-rater reliability. Inter-rater agreement ($r=0.86$, $P<.001$) on the survey measures concerning the five competitive strategies was significant and consistent with the literature (e.g., Zahra, Neubaum and Huse, 2000; Hagen, Hassan and Wilkie, 2003; Hagen and Lodha, 2004; Hagen and Haj, 2004).

Following the work of Osterman (1994), the logistic regression was utilized to detect potential biased responses. The dependent variable defined as a dummy variable coded 1 if the CEO of the company responded and 0 if he or she did not respond. The independent variables included age, size, and labor productivity of both responding and non-responding firms. The outcome of the logistic regression indicated that response biasness was not a significant problem for CEOs' responses. Utilizing the work of Zahra, Neubaum and Huse (2000), both samples of this study were investigated to determine whether the sample represented the target populations. The number of full-time employees, age, and labor productivity of the responding and non-responding firms were compared. The t-tests and the X^2 tests did not reveal significant differences between the two groups. Thus, each sample represented its target population.

Subsequently, the factor structure of the scales was investigated by incorporating all scales of the five competitive strategies into a separate confirmatory factor analysis (CFA). The CFA conducted on the data collected from the responding CEOs revealed that the measures were distinguishable from one another. CFA is presented in the Appendix.

To ensure that the regression model has not been undermined by any potential problem, certain statistical tests have been used to check the existence of any problem. Multicollinearity is not a problem because all variance inflation factors (VIFs) are low. Autocorrelation does not exist because the Durbin-Watson statistic is significant (D.W.=2.4). The plot of the residuals shows that there is no evidence of heterosedasticity. Neither the Studentized Deleted Residuals Test identified influential outliers for the dependent variable, nor Diffits and the Cook's Test detected influential outliers for the independent variables. The plotted histogram of data depicted normal distribution of the data. The plot of the dependent variable against each of the independent variables showed a linear relationship between these perspective variables.

FINDINGS OF THIS STUDY

The matrix correlation presented in Table 1 shows moderate correlations among variables. These correlations indicate that the five competitive strategies recommended in global markets are not completely independent. These correlations were expected because the items measuring the firm's labor performance measures are interrelated. However, such moderate correlations should not be considered a serious problem in previous research (Hagen, Udeh and Hassan, 2001).

Table 1 also shows correlations between the five competitive strategies (adapt to local market differences, exploit economies of global scale, exploit economies of global scope, tap optimal locations for activities and resources, and maximize knowledge transfer across locations) in global markets and the firm's labor productivity. Although *adapt to local market differences* is correlated with the other four competitive strategies, *exploit economies of global scale* is correlated with *exploit economies of global scope* ($r=.28$; $P<.01$). However, this strategy is not correlated with *tap optimal locations for activities and resources* or *maximize knowledge transfer across locations*. On the other hand, *tap optimal locations for activities and resources* is correlated with *maximize knowledge transfer across locations* ($r=.18$; $P<.05$).

Labor productivity is correlated with four of the five strategies. It is correlated with *adapt to local market differences* ($r=.14$; $P<.10$), *exploit economies of global scale* ($r=.17$; $P<.05$), *tap optimal locations for activities and resources* ($r=.16$; $P<.05$), and *maximize knowledge transfer across locations* ($r=.21$; $P<.01$). This notion refers to a potential relationship between the suggested competitive strategies and a firm's labor productivity. Finally, while labor productivity is correlated with the firm's sales growth ($r=.27$; $P<.01$), it is not correlated with the firm's size or its relative capital intensity. Thus, one of the three control variables is correlated with the firm's labor productivity.

Data analysis in Table 2 reveals a positive and significant relationship ($P<.01$) between *adapt to local market differences* and the firm's labor productivity in global markets. This finding supports the first hypothesis which proposed *a significant and positive relationship between adapt to local market differences and the firm's labor productivity in global markets*. This finding indicates that the CEOs' local adaptation of products and services has expanded their boundaries, which included their customers within countries who value different features and attributes. It also appears that tailoring products and services to the preferences of local customers enhanced the value delivered to them. As a result, a portion of this increased value has been translated into high price realization for the firms. Finally, CEOs' concentration of their global purchasing power over certain suppliers generated discounts and lower transaction costs. Utilizing global purchasing power over competitors, CEOs were able to convert their firms' global presence into global competitive advantage.

Table 1: Correlation Matrix for the Responses of American CEOs to the Five Competitive Strategies in Global Markets and Its Labor Productivity Measure

Management Practices	1	2	3	4	5	6	7	8	9
Adapting to local market differences	1								
Exploiting economies of global scale	0.11	1							
Exploiting economies of global scope	0.04	.28	1.0						
Tap optimal locations for activities and resources	0.05	-.04	.16	1.0					
Maximizing knowledge transfer	0.1	.16	.11	.18	1.0				
Firm's labor productivity	0.14	.17	0.08	.16	.21	1.0			
Firm's size	0.19	0.15	0.07	0.16	0.17	-0.12	1		
Firm's relative capital intensity	0.1	.15	.19	.12	0.19	-0.1	0.15	1.0	
Firm's sales growth	0.18	.14	.08	.07	0.25	.27	.17	.16	1.0

Correlations greater than .14 and less than .18 are significant at P< .10; correlations greater than .18 but less than .24 are significant at P < .05; correlations greater than .24 are significant at P < .01; all two-tailed tests.

There is a similar positive and significant relationship (P<.05) between *exploit economies of global scale* and the firm's labor productivity in global markets. This finding supports the second hypothesis which proposed a *significant and positive relationship between exploit economies of global scale and the firm's labor productivity in global markets*. This finding reveals that the global presence of firms has expanded their scales of operations and has given them substantial revenues and larger asset bases. That is, CEOs of these firms have obtained benefits from spreading fixed costs over larger volume, reducing capital and operating costs per unit, and creating requisite critical mass in selected activities.

In contrast, *exploit economies of global scope* has a positive and marginal relationship (P<.10) with the firm's labor productivity in global markets. This finding provides partial support for the third hypothesis which proposed *a significant and positive relationship between exploit economies of global scope and the firm's labor productivity in global markets*. Despite the global presence of these firms, CEOs could not provide coordinated products and services to their global customers. It is also possible that the market power of these firms is less effective than that of their competitors.

Table 2: Regression Analysis of Variance for the Five Competitive Strategies in Global Markets and Labor Productivity Measure

Independent Variables	Dependent Variable: Firm's Labor Productivity		
Competitive Strategies in Global Markets	Beta	T-value	P
Adapting to local market differences	0.2167	4.27	0.01
Exploiting economies of global scale	0.2824	8.15	0.01
Exploiting economies of global scope	0.1139	1.58	0.1
Tap optimal locations for activities and resources	0.1547	2.74	0.05
Maximizing knowledge transfer across locations	0.1663	2.46	0.05
Firm's size	0.0743	0.87	0.48
Sales growth	0.2513	5.31	0.01
Relative capital intensity	0.0168	0.72	0.52
R^2=48; Adjusted R^2= 38; F-value 14.79; P < .001			

Tap optimal locations for activities and resources has a positive and significant relationship (P<.05) with the firm's labor productivity. This finding supports the fourth hypothesis which proposed that *there is a significant and positive relationship between tap optimal locations for activities and resources and the firm's labor productivity in global markets*. In spite of the increasing integration of global economies, these CEOs acknowledged that cultural differences would continue for years to come. Exploiting inter-country differences in their global locations in terms of product and services, CEOs have created competitive advantages over their rivals. It also appears that the proper choices of their locations have enhanced firms' performance and reduced costs and risks.

Finally, *maximizing knowledge transfer across global locations* is positively and significantly (P<.01) related to the firm's labor productivity in global markets. This finding supports the fifth hypothesis which proposed *a significant and positive relationship between maximizing knowledge transfer across global locations and the firm's labor productivity in global markets*. This finding indicates that CEOs have considered their global firms as portfolios of knowledge centers rather than portfolios of subsidiaries with tangible assets. This consideration enabled CEOs to hasten product innovation, lower the cost of their innovations, and reduce the risk of competitive preemption through effective transfer of knowledge across subsidiaries.

IMPLICATIONS AND CONCLUSIONS

CEOs should never assume that global presence by itself is the same as global competitive advantage. Having global presence implies that a firm has available five distinct opportunities to create global advantage; local adaptation, global scale, global scope, location, and knowledge transfer. To achieve global competitiveness, firms have to adopt the suggested competitive strategies. They must also be prepared to overcome any obstacles that arise during the implementation of these strategies.

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Appendix A—Confirmatory Factor Analysis (CFA)
Properties of the Competitive Strategies

Construct and its Indicator Variables	Factor Loadings	Cronbach Alpha	Composite Reliability
1. Adapting to local market differences		0.8126	0.8214
* Draw an accurate distinction between those attributes where the customer truly appreciates adaptation and those attributes where the customer is either neutral or averse to adaptation.	0.7258		
* Evaluate the customer's willingness to pay for those attributes where adaptation adds value.	0.6922		
* Manage your product design and manufacturing activities in such a manner that you can offer the needed inter-country variety at the lowest possible cost.	0.813		
* Have sensing mechanisms (such as market research and experimental marketing) that would give you early warning the needed inter-country signals about increases or decreases in customers' preferences for local adaptation.	0.6637		
2. Exploiting economies of global scale		0.7258	0.7325
* Exhaust all possibilities in designing your products to utilize concepts such as modularization and/or standardization of subsystems and components.	0.7341		
* Fully assess the benefits from economies of scale against any resulting increases in other costs, such as transportation and tariffs.	0.8022		
* Establish effective and efficient coordination mechanisms so that you do not squander the benefits from scale economies.	0.6813		
* Build world-class competencies in the locations where you have chosen to concentrate on the scale-sensitive activities.	0.7135		
3. Exploiting economies of global scope		0.7126	0.7154
* Make your internal coordination of marketing activities across locations at least on par with (and preferably ahead of) the extent to which your customers have integrated their own purchasing activities.	0.5839		
* Be sure that you understand various pulls and pushes shaping the needs and buying decisions of your customer's global network.	0.6247		
4. Tapping the optimal locations for activities and resources		0.8352	0.8501
* Ensure that your location-based advantages are neither squandered nor neutralized by competitors because of any weaknesses in quality and productivity of your internal locations.	0.7352		

Appendix A—Confirmatory Factor Analysis (CFA)
Properties of the Competitive Strategies

Construct and its Indicator Variables	Factor Loadings	Cronbach Alpha	Composite Reliability
* Ensure that you have the organizational and resource flexibility to shift locations over time, as some other locations begin to become more optimal than your current locations.	0.7852		
* Ensure that your coordination across the various locations does not resort in any frictions.	0.8011		
5. Maximizing knowledge transfer across locations		0.7823	0.7846
* Be sure that you are able to discover the opportunities for knowledge transfer routinely and systematically.	0.7137		
* Be sure that your subsidiaries are enthusiastic about sharing knowledge with other units.	0.8215		
* Be sure that your subsidiaries are eager to learn from any and all sources, including peer subsidiaries.	0.6847		
* Build efficient communication mechanisms for the sharing of codified know-how across locations.	0.8137		
* Be able to keep codified knowledge proprietary to your company.	0.6624		
* Build effective mechanisms (e.g., people transfer, face-to-face interchange) for the transfer of tacit knowledge across locations.	0.7623		

GAINING A PERSPECTIVE ON TURKISH VALUE ORIENTATIONS: IMPLICATIONS FOR EXPATRIATE MANAGERS

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ABSTRACT

Turkey's emergence as a significant player in the international business arena and its potential membership with the EU have created a need to gain a better understanding of Turkish cultural values. The primary objectives of this paper are to offer Western expatriate managers (US, UK, Germany, France, Holland, etc.) an accurate perspective of Turkish national culture and discuss their impact on business practices. This paper also uses the case of dualistic forces in Turkish culture to illustrate the types of sub-cultural dynamics that are common in many societies and the implications of these tensions for cross national management.

INTRODUCTION

Turkey is strategically located at the cross-roads of southwestern Asia and southeastern Europe bordering the Black Sea and the Mediterranean Sea, sharing its northwestern border with Greece and Bulgaria; its western border with Georgia, Armenia, and Iran and its southeastern border with Syria and Iraq. Turkey has a population of approximately 69 million of which 80% are Turkish and 20% Kurdish. The predominant religion is Islam (99.8%) with Christians and Jews making up rest of the population. The official language is Turkish but other regional languages include Kurdish, Arabic, Armenian, and Greek. Turkey has the distinction of being the only secular democracy among the world's 52 Muslim states. Additionally, Turkey was also identified as one of the "big 10" emerging economies by the Clinton administration (CIA World Fact book 2003; Economist country briefings: Turkey, 2005)

The Turkish economy has gone through some dramatic structural changes. Starting from the 1980's and through the 1990's the Turkish economy transitioned from a controlled centralized system that believed in import-substitution dominated by state run enterprises to a market based model where the private sector has emerged as a key player. State-owned assets such as *Turk Telecom* are being auctioned as part of the privatization effort. These measures are expected to fetch approximately $7 billion which will be used to pay off the national debt which is estimated to be 7 per cent of Turkey's gross domestic product (Cave and Firn, 2005). Additionally, restrictions have eased on foreign investors and businesses.

The share of agriculture as a percentage of GDP has steadily decreased to 15% while services sector accounts for 58% (Aycan, 2001). With a GDP of $240 billion, the Turkish economy is currently ranked as 17th largest in the world. The leading trading partners are Germany, UK, US, Italy, Russia, Switzerland and France. The EU has not only emerged as the largest supplier for Turkey accounting for 46% of all supplies, it is also the largest market for Turkish goods accounting for 52% of all Turkish products. Of the top 175 investors, 16% are from France, 13.2% from Germany, 11% from Holland, 10% from Japan, 7.4% from Switzerland, and 7% from the USA (Yavas and Bodur, 1999; Economist country briefings: Turkey, 2005).

The liberalization of the Turkish economy and the transition to a free market has increased interaction between Turkish nationals and managers from Europe, UK, and the US. The level of business activity is expected to increase with Turkey's projected membership into the EU community scheduled for 2015. Despite these developments, many Western managers continue to harbor several fears, doubts, and stereotypes of Turkish culture (Dombey and Boland, 2005). A large number of Europeans have serious concerns about Turkish identity with European culture and commitment to secularism. In an article published in the *Financial* Times (Parker, Minder, and Boland, 2004, p. 4), Jean-Pierre Raffarin the French Prime Minister was quoted in a Wall Street Journal interview with the following comment: "Do we want the river of Islam to enter the riverbed of secularism?"

The skepticism was further enhanced when the Turkish government proposed a change to the penal code in 2004 that would make adultery a criminal offence. While this proposal was considered to have grassroots support by many Turkish citizens, there was a general outcry in Europe that this proposal was an "invasion of privacy" and incompatible with European codes of human rights (Boland and Dobey, 2004). Others saw it as an attempt to infuse an Islamic religious doctrine into a secular lifestyle. This move seriously jeopardized Turkey's accession talks with the EU community—the issue was finally resolved when the Erdogan administration withdrew the proposed legislation.

The continuing modernization of the Turkish economy and Turkey's interest in the EU suggest the predominance of a utilitarian, capitalist mindset, but the country's Islamic heritage and patterns of political mobilization suggest otherwise. This apparent contradiction leads to several questions: "Is Turkey a secular state or an Islamic one? Are Turkish values and beliefs impacted by religion? Are values and beliefs followed uniformly throughout the country? Are there cultural differences between urban and rural areas? Are Turkish citizens conservative or progressive? Do women have the same rights as men?" The answers are of interest to Western managers and others seeking a better understanding of Turkish culture and values.

Table 1
Economic Indicators

Population (m)	72.3 million (2004)		
Median age	27.3 years		
Life expectancy	72 years		
GDP (purchasing power parity)	$567.19 billion (2004)		
GDP composition by sector	agriculture: 11.7%		
industry:	29.8%		
services:	58.5%		
GDP growth rate	4.3% (2004)		
Labor costs per hour (USD)	1.81		
Labor force	23.79 million		
Recorded unemployment	10.65%		
Major Exports (2004)	% of total	Major Imports (2004)	% of total
Clothing and textiles	27.9	Machinery & appliances	22.4
Road vehicles	13.1	Petroleum products	14.8
Electrical machinery	8.4	Iron & steel products	10.5
Iron and steel	7.6	Road vehicles	8.2
Fruits and vegetables	3.8	Plastics and vegetables	4.9
Total exports (USD billion)	61	Total imports (USD billion)	60.8
Leading markets (2004)		Leading Suppliers (2004)	
Germany	13.9	Germany	12.8
UK	8.8	Italy	9.3
US	7.7	Russia	7
Italy	7.4	France	6.4
France	5.8	US	4.9
EU	54.6	EU	46.6

* compiled from General Directorate of Foreign Investment and General Directorate of Foreign Exchange of Treasury-Country Commercial Guide; http://economist.com/countries/Turkey; CIA World Fact book 2003; U.S. Department of State Country background notes (source date: 08/04) retrieved from http://globaledge.msu/ibrd/countryeconomyprint.asp?CountryID=76&regionID=2

Other Indicators
Corruption Perception Index-2004: Score: 3.2 (77 out of 146 countries)
IMD Word Competitiveness Yearbook 2005: Score 51.293 (48 out of 60 countries)
Index of Economic Freedom 2005: Score 3.46 (112 out of 155 countries)

Table 2
Turkey: A chronology of key events

Date	Events
1923	Once the centre of the Ottoman Empire, the modern republic was established by nationalist leader Kemal Ataturk. Assembly declares Turkey to be a republic and Kemal Ataturk as president. Sweeping social, political, linguistic, and economic reforms are introduced to form the new ideological base for Turkey. In the post-Ataturk era, his reforms began to be referred to as "revolutions." Kemalism comprises a Turkish form of secularism, strong nationalism, statism, and to a degree a western orientation.
1924	Rights for women to be elected for the parliament
1925	Adoption of Gregorian calendar. Prohibition of the fez. Hat was introduced
1928	Turkey becomes secular: clause-retaining Islam as state religion removed from constitution
1928	Introduction and the acceptance of the Roman alphabet
1931	The Metric system was introduced
1934	Religious attire was prohibited in public
1949	Membership to the Council of Europe
1952	Turkey abandons Ataturk's neutralist policy and joins NATO
1963	Association agreement signed with European Economic Community (EEC)
1987	Turkey applies for full EEC membership
1995	Pro-Islamist Welfare Party wins elections but lacks support to form government - two major centre-right parties form anti-Islamist coalition.
1996	Centre-right coalition falls. Welfare Party leader heads first pro-Islamic government since 1923.
1998	Welfare Party - the largest in parliament - banned.
1999	Recognition as Candidate for EU accession
2001	Constitutional Court bans opposition pro-Islamic Virtue Party, saying it had become focus of anti-secular activities. New pro-Islamist party Saadet is set up by former Virtue Party members in July. EU has asked Turkey to limit military's role in politics
2002	Turkish men are no longer regarded in law as head of the family. The move gives women full legal equality with men, 66 years after women's rights were put on the statute books.
2002	Islamist-based Justice and Development Party (AK) wins landslide election victory. Party promises to stick to secular principles of constitution. Secularists regard headscarves as symbols of radical Islam
2002	Parliament approves reforms aimed at securing EU membership.
2003	Eyeing future EU membership, parliament passes further laws easing restrictions on freedom of speech, Kurdish language rights, and on reducing political role of the military.
2004	Turkey signs protocol banning death penalty in all circumstances, a move welcomed in EU circles
2004	Turkish state television broadcasts first Kurdish language program
2004	Parliament approves penal code reforms introducing tougher measures to prevent violence against women and torture. Controversial proposal on criminalizing adultery dropped.
2004	EU leaders agree to open talks in 2005 on Turkey's EU accession.

We speak to these questions in this paper, but our more important contribution will be to identify the ambivalence that exists around traditional and modern values in Turkey itself, and how Turkish society expresses and deals with this ambivalence. Besides dispelling negative stereotypes, we hope our ideas will enable Western expatriates to adapt their business and other management practices to be compatible with Turkish culture.

EVOLUTION OF TURKISH VALUES-THE PRESENCE OF DUALISM

Turkey is a country whose history spans many centuries across two continents. It is imperative to gain an understanding of Turkey's history to understand Turkish values. At its height, the Ottoman Empire centered in Turkey was not only one of the largest empires in the world but was also the largest European kingdom as well. As early as the 19th century, the Ottoman Empire absorbed several European influences that were willingly accepted by the ruling segment of the population—these values were further reinforced by the republic established by Kemal Ataturk in 1923.

In his quest to establish a modern secular state fashioned after the European model, Ataturk created a separation between the state and religion (Islam), borrowed heavily from the French and Swiss legal systems, created a secular educational system, adopted Latin script languages, and banned women from wearing veils and headscarves. Such reforms were willingly accepted by an urban population that was Westernized, secular, and part of the power elite-- but grudgingly tolerated by the rural populace which was more traditional and conservative by nature. After Ataturk's death, earlier traditions began to resurface-- there was an increased appreciation among the Turkish people towards their Ottoman past and a gradual loosening of the tight compartmentalization of religious expression and symbolism in public life (Rouleau, 1993).

Scholars who have studied modern day Turkish culture have noted the "dualism" that is characteristic of Turkish society that has evolved due to a juxtaposition of Western secular values with traditional Turkish values such as conservatism and collectivism (Wasti, 1998; Kasaba and Bozdogan, 2000; McDaniel, 2003). Dualism also exists as the pace of industrialization and modernization has impacted different segments of Turkish society in very different ways. As noted by Cavusgil et al., 2003, p. 476), "…in major urban areas there is the same cosmopolitan atmosphere found in any modern city in terms of infrastructure, lifestyles, fashion, and shopping habits. In the rural sector, traditional social values are still safeguarded." Wasti (1998, p. 15) notes, "…there is a striking difference in the values and lifestyles of the 'Westernized' urban segments of the society when compared to the rural population and city dwellers."

In his study of Turkish sub-cultures, Kozan (2002) identified two distinct groups in Turkish society: the first group (*Egalitarians*) continues to press for Westernization, secularism, and modernization whereas the second group (*Traditionalists*) would like to adhere to a more traditional outlook and lifestyle infused with Islamic values (not be confused with those advocating a fundamentalist perspective). Members of the military, civil bureaucracy, and long-time urban residents display a secular and Western outlook. *Traditionalists* are predominantly from smaller towns, villages, rural areas and include recent migrants to big cities. Historically members of the latter group have not occupied the seat of power but their numbers are growing and many political parties are paying greater attention to their needs and aspirations.

Traditionalists emphasize values such as hospitality, politeness, devoutness, preservation of public image, obedience, social recognition, social order, reciprocation of favors, chastity of women, and respect for tradition among other values (Kozan, 2002; p. 93). *Egalitarians* emerged during Ataturk's era and espoused values that revolved around equality, application of universal rules and role based transactions instead of reciprocal obligations that have evolved due to social relationships, and collectivism. The Turkish military and others in the power structure have continued to staunchly defend the "Kemalist" system that advocates separation of state and religion (Islam).

In recent years, Turkish society has witnessed a relocation of *Traditionalists* from rural areas to cities where *Egalitarians* have traditionally tended to dominate. These rural participants have become very active in Turkish politics and industry (Kasaba and Bozdogan, 2000). This increased contact between the two groups with very different values has created a tension in Turkish social life. Kasaba and Bosdogan (2000), This contact has led to the emergence of a third group in the Turkish social scenery that is a hybrid of both Traditional and Egalitarian values.

According to Kasaba and Bozdogan (2000, p. 7),

> *By the 1990's, most of those who were in the forefront of Islamist politics in Turkey were engineers, doctors, lawyers and other professionals and they articulated an ideology that blended (our emphasis) social conservatism with remarkable flexibility and openness regarding Turkey's economic and technological integration with the outside world. As an increasingly diverse population congregated in big cities, this blend of Islam and modernity created a cultural outlook that is relatively open, flexible and more sure-footed than that of the older elite. Today, this segment of Turkish society is becoming increasingly well represented in the most prestigious schools as well as in the newly expanding fields of communications, finance, international commerce, and investment.*

After reviewing several studies that examined contemporary Turkish Culture, Karakitapoglu-Aygun (2004) and Fullager, Sumer, Sverke, and Slick (2003), theorize that Turkish culture is transitioning in a shift towards Individualism. Yet the nature of Individualism is uniquely Turkish in that it is "accompanied by deep-seated traditional values related to being a member of an in-group" reflecting a hybrid of traditional Turkish and Western values."

We label this emerging third cultural group as Turkey's *Islamic Democrats* and consider them to represent a middle position in the continuum of Turkish society. The vast majority of *Islamic Democrats* support globalization and Turkey's membership in the European Union. Further they consider open relations with Western nations as one of the best guarantees of political and religious freedom.

From the discussion above, it seems clear that there are at least three important sub-cultural orientations in Turkey today, and that the way these orientations compete and interrelated needs to be understood if theoretical and practical miscues are to be avoided. And while Turkey may be somewhat unique in the extent or the particular contours of its dualism, it is not likely alone. We suspect the nations that Organski (1965) labeled "old countries"—those with longstanding and highly developed cultural identities and traditions—are likely to exhibit similar dualisms. India, Thailand, China, and Japan come to mind among others. Even modern, secularized, capitalist nations may not be exempt. In a tri-national study of organizational culture, Nelson and Gopalan (2003) found that not only Indian and Brazilian organizations experienced traditional versus modern dualisms in their organizational cultures; North American organizations also showed evidence of cultural ambivalence around core capitalistic values.

TURKISH CULTURAL VALUES AND THEIR IMPACT ON MANAGEMENT PRACTICES

A number of studies (Hofstede, 1980; Ronen 1986; Trompenaars and Hampden-Turner, 1998) have identified Turkish culture as being high on *collectivism*, *power distance*, and *conservatism*. Kabasakal and Bodur (1998) noted the presence of feudal relationships that characterized leader-follower relations. This has resulted in many Turkish organizations having: centralized-decision making structures, highly personalized leadership that is both autocratic and paternalistic, an emphasis on hierarchy, and an expectation of a patronage relationship. Pasa's (2000) study on leadership influence in Turkish organizations found that those in leadership positions simply use their "formal power/authority" to obtain compliance from their subordinates. Leaders frequently assume the role of a parent, remove all discretionary responsibility from subordinates, and provide advice, counsel, and protection at all levels. In return, the subordinates are expected to provide absolute loyalty and support. Yavas and Bodur (1999) note that family members (not professional managers) are in top leadership positions in many Turkish organizations. Family owned conglomerates are fairly common in Turkey, similar to organizational structures found in India and many Latin American countries (Cavusgil et al., 2003). Trust resides with family members.

Western managers must demonstrate sensitivity and flexibility in their leadership styles to be effective with Turkish peers and subordinates. Turkish subordinates may exhibit a high degree of dependency by frequently asking for advice and guidance. Such behaviors should be viewed in the context of long standing Turkish culture that has emphasized high power distance and dependence. Loyalty is expected and rewarded-Turkish subordinates will go the extra mile towards superiors who cultivate personal loyalty. A paternalistic yet personalized leadership style may be most effective with many subordinates (Pasa, 2000). Alternatively there may be others schooled in

Western thought who are independent in their behavior and outlook. Leadership styles that delegate authority and independence and which are participatory in nature should be more effective with the latter group.

Figure 1
Turkish Subcultures

Traditional Turkish Values from the Ottoman era	↔	Islamic Democrats	↔	Egalitarian Values from the Ataturk era
Arabic insular collective hospitality feudal collective		Religious Muslim progressive pro-Europe/pro-Western hospitality upward mobility individualistic + collective		Western secular hospitality democratic equality of sexes collective

Turkish culture places a premium on *being hospitable*, *cultivating personalized relationships*, and *saving face* (Cavusgil, Civi, Tutek, Dalgic, 2003; Kozan and Ilter, 1994). Turks are warm and generous hosts and regardless of one's socio-economic status, guests are treated with great honor (*misafir*). Expatriates (especially from European and Anglo cultures) may consider lavish displays of food and drink to be excessive—but from the Turkish perspective, guests are seen as symbols of good fortune to one's home and are treated accordingly. In social situations, there is an expectation that each and every person in a room should be *personally greeted*—not doing so, is considered as an insult resulting in an individual to lose face. Turkey is a *high context culture* where verbal communication and personalized face-to-face contact are emphasized more than written communication. Therefore, business lunches and dinners tend to be more formal and lengthy in nature.

Personal and professional relationships overlap in Turkish culture. Unlike Western cultures, where friendship obligations are generally not extended to work related issues, the Turkish people have a broad concept of friendship which may include requests for work-related favors. An expectation of reciprocity based on friendship may be viewed as an intrusive habit by Western expatriates. On the other hand, lack of reciprocity may be viewed as a disappointment by Turks—resulting in loss of face. This has the potential of creating a misunderstanding and damaging a productive business relationship. Expatriates are encouraged to use indirect, subtle, and face-saving communication techniques if they are unable to comply with such requests.

Turkish culture is *polychronic* with respect to time orientation. Western expatriates may find that their conversations with Turkish executives may be delayed, interrupted by phone calls or visitors and staff walking in and out of scheduled meetings. Managers raised in monochromic time oriented cultures may leave with an impression that the workplace is chaotic, unorganized, with very little privacy. But in Turkey, an effective manager is one who deals with multiple tasks while interacting with several individuals *immediately* and *simultaneously*. This is a critical skill that managers would need to possess to be successful in Turkey. Notwithstanding *polychronic time orientation*, punctuality is important and expected in business settings. The emphasis regarding punctuality is *mixed*; it is more important in urban than rural areas.

Aycan (2001) notes that many Western human resource (HR) management practices should be modified for Turkish work environments. Given the high power distance in Turkish culture, performance evaluations tend to be one way, i.e. from the superiors to the subordinates. Self-assessment exercises are generally ineffective as Turkish employees tended to rate themselves considerably lower than their superiors. This information suggests that the use of 360 degree feedback processes may have limited relevance in Turkish work environments. Giving negative feedback in a direct manner may create conflict as saving face and maintaining group harmony are important in Turkish culture.

Aycan (2001) cites an Arthur Anderson study conducted in 2000 that examined human resource management practices in 307 private sector Turkish organizations. Recruiting is primarily done using one-on-one interviews—testing as a recruiting tool was used by only 10% of the sample. Extrinsic rewards such as bonus and salary increases are popular and widely used. Intrinsic rewards that single out individual achievement and performance are not very popular—singling out one individual over others in a group is unpopular in a collective culture that values group harmony. The most important factor impacting salary increase is the inflation rate followed by individual performance and tenure with the company. The study concludes that while few Turkish firms have world-class HR processes and systems in place, overall HR practices in the majority of Turkish organizations are in a nascent state.

In two separate studies, Kozan (1989, 2002) found that hierarchy played a significant role in impacting Turkish conflict management styles. Overall, the tendency is to be more accommodative towards one's superiors (respect for authority); suppressing/and or avoiding competition between peers (focus on collectivism and group harmony); and imposing solutions on subordinates (analogous to a parent-child relationship). *Traditionalists* and *Egalitarians* chose problem-solving as the most preferred approach suggesting a social desirability bias (Kozan 2002). *Traditionalists* chose avoidance as the fallback option while *Egalitarians* chose accommodation as their fall back option. These results have implications for expatriate managers working for multinationals who will deal with a variety of Turkish nationals. They need to be trained to identify diversity and become familiar with appropriate conflict resolution styles of various Turkish groups.

Given uncertainty around the degree to which Turks are willing to set aside traditional beliefs and practices in favor of secularism and equalitarianism, an issue of great interest would be the assignment of women expatriate managers to Turkey. Subject to certain conditions, Taylor and Napier (2001, p. 359) mention that "In general, if properly prepared, a woman professional should have no great difficulty in working successfully in Turkey, and can be just as successful if not more so than a foreign man." Women executives can maximize their effectiveness in a variety of ways: by working in certain types of occupations such as accounting and banking over others like agriculture; occupying a senior position in a multinational or a large Turkish holding company; being older, working and living in bigger cities like Istanbul and Ankara which have several entertainment and social outlets; and being married. A large amount of Turkish social life revolves around the family-consequently, socializing options are limited for single women.

The response to taking orders from and working with women managers to a large extent depends upon the location and the sub-cultural group to which a Turk belongs. Urban Turks are very progressive and sophisticated. In their immediate families, both men and women attend universities, obtain degrees, and hold high positions in organizations. As an example, we would like to cite the case of Guler Sabanci (niece of Sakip Sabanci) who became the CEO of the Sabanci Holdings; a $12 billion dollar conglomerate and one of Turkey's largest multinationals (Breaking into a man's world, 2005). Woman expatriate managers who work with Turkish individuals with this background (urban, secular, Western outlook) will encounter little or no difficulty in having a productive work relationship (Karakitapoglu-Aygun, 2004). However, women expatriate managers will face difficulties when dealing with Turkish men whose origins are from small villages and rural areas. These men have traditionally "ordered" their wives and daughters and resist taking orders from a woman manager.

The secular values adopted by Ataturk, gave women access to institutions of higher learning and the right to vote. On the flip side, since women are considered to be responsible for raising children and maintaining family relationships, these societal expectations again act as barriers to career advancement. These factors are an illustration of the dualism that is characteristic of Turkish society. Turkish women comprise 36% of the labor force population (Fullager et al., 2003). All trends indicate an increasing participation of women in Turkish organizations.

CONCLUSION

We hope that the earlier discussion aids in the success of Western expatriates who are assigned to Turkey. This information should be considered as a starting point to an expatriate's cross-cultural awareness of Turkey. Needless to say, depending upon the length of stay and degree of interaction with host country nationals, expatriates may need more rigorous cross-cultural training (Black and Mendenhall, 1989). There are several trends/issues that Western expatriates must keep in mind as they consider doing business in Turkey.

First, Turkey's ties to Europe are bound by history and commerce. Turkey is a member of NATO, OECD, the Council of Europe, the Conference of Security and Cooperation in Europe, etc. Turkey receives huge capital inflows from European countries; its primary trading partners are all based in Europe. As Turkey's projected date of 2015 looms closer, the pace of free market reforms and openness of Turkey's economy will continue to increase. With its large and young population (57% of Turkey's population is under the age of 30) and proximity to many countries, Turkey will continue to remain a very attractive market for locating manufacturing activities and for selling consumer durables.

Next, Turkey is a diverse country and the expatriate manager will experience diversity in their interaction with Turkish nationals. For our discussion, three groups were identified and discussed—these 3 groups should be considered representing a continuum in Turkish society. *Traditionalists* represent Turkish values that predate the establishment of the Republic; the *Egalitarians* who represent Western secular values that Kemal Ataturk sought to inculcate; and the *Islamic Democrats* who combine elements of the previous two groups. Expatriates must understand that the Turkish people with whom they have most initial contact and with whom they communicate most easily are likely to belong to a subgroup that is not representative of the entire country in aspirations or perspective. Those who are likely to work with a foreign manager are by education, social class and political orientation, if by not temperament, likely to belong to subgroups that are numerically small and that vary from other subgroups in important ways.

Due to the dominance of military and the ruling establishment, expatriates are more likely to come into contact with members of the *Egalitarians* as they are disproportionately represented in organizations (especially multinationals) as managers or executives. But as the power and number of *Traditionalists* increase, expatriates will increase their contact with this group as well.

Expatriate managers must first learn to recognize cultural differences among Turks and become aware who they are dealing with. Conflict-resolution or communication styles that work with *Egalitarians* may be ineffective with *Traditionalists* and vice versa. Expatriates must understand that almost any program, policy, or administrative action they frame will be interpreted in at least two different ways, depending on the perspective of a subgroup member. Moreover, these interpretations may seem to be quite distant from the meaning that the manager sees in his/her action. Even in relatively homogenous countries and organizations, there is dissension around many seemingly technical decisions. Actions are interpreted in terms of what subgroups stand to gain or loose from a given action and the symbolic value of an action may be as important as its practical impact. In dualistic nations such as Turkey, this is even more likely to be the case.

It is probably unrealistic for expatriates to expect to be equally accepted by all the major subgroups in a society. In such instances, it is best not to take negative reactions personally. In a polarized situation, it is almost impossible not to be seen as partial to one side or another. At the same time, the manager should try to at least catalogue which groups exist, and gain some knowledge of their major catchwords, heroes, spokespersons, and symbols. Among these will be some that are particularly sensitive, or which have surplus meanings that far beyond their simple translation from one language to another. Before any major address, ceremony or memorandum, check with at least a couple of Turkish nationals to gauge the likely impact of a position on different groups. While it may not be possible to please everyone, it is foolish to antagonize host country nationals needlessly or carelessly.

Partly due to history and partly due to recent events such as 9/11 attacks on the World Trade Center and other acts of terrorism by a religious minority, many in the West are unable to differentiate between moderate Muslims versus Islamic fundamentalism and extremism. They are unable to distinguish between the dictates of a theocratic state like Iran versus a vibrant democracy like Turkey where many Turks who are active devout Muslims also wish to live in a secular country. The adoption of a democratic political system combined with free-market reforms have been instrumental in creating a more open and free atmosphere where many Turks are able to appreciate their Ottoman culture and heritage and freely practice Islam. According to Kramer (1999) and Cukur, De Guzman and Carlo (2004), Islam will continue to play an important role in Turkish politics, but it is exemplified by a progressive outlook that is appealing to many urban middle class residents and younger generation. Europeans and others who deal with Turkey must acknowledge this emerging image as a fact. Indeed one might speculate that Turkey's comparative economic vitality compared to other Muslim nations comes from an ability to embrace many aspects of modernism while enjoying the benefits of a rich cultural tradition.

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FOREIGN AID AND THE POTENTIAL EFFECTS ON INCOME INEQUALITY IN RECIPIENT NATIONS

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ABSTRACT

Foreign aid can be effective in promoting economic growth and reducing poverty but there are also cases where aid has been wasted by the recipient nation. This study examines the effectiveness of foreign aid on income inequality, as measured by the GINI coefficient. Several studies have documented that foreign aid has a positive effect on economic growth, but few studies have focused on the impact that aid has on income inequality. While economic growth should benefit the economy as a whole, economic growth does not imply that income inequality will improve. Using data for twenty-nine countries and controlling for a variety of factors, the results of the study suggest that increased aid may actually be associated with higher levels of income inequality in the recipient nations. However, the results are sensitive to model specification.

INTRODUCTION

"Foreign aid has at times been a spectacular success – and an unmitigated failure."
"Assessing Aid: What Works, What Doesn't, and Why," World Bank Policy Paper (1998)

Foreign aid is a heavily researched topic. It is controversial from the standpoint that, when used correctly, aid has a tremendous impact on a developing economy. But, when used incorrectly, it is squandered, or worse, lines the pockets of a few individuals. Foreign aid levels reached their peak during the 1970s and 1980s and started to decline in the 1990s. Up until the 1990s, research indicates that foreign aid was given equally to countries with good and poor economic management. However during the 1990s, this changed due to the finding that foreign aid is more effective in countries with stable macroeconomic policies.

This study enhances the body of literature on aid effectiveness by investigating the influence that foreign aid has on changes in income inequality for a sample of 29 countries. After controlling for various factors, the results of the study suggest that foreign aid negatively impacts changes in income inequality. The results, however, are sensitive to model specification.

LITERATURE REVIEW

Although very little research could be found on the direct relationship between foreign aid and income inequality, there is a plethora of research on the effectiveness, if any, of aid on recipient countries. There is also a significant body of research on the determinants of aid policy in donor nations and the main focus from this area will be how these policies appear to have been changing in recent years.

Evidence that aid has begun to be allocated differently is provided by Dollar and Levin (2004), where they examined the allocation of foreign aid by 41 donor agencies. They found that there is a clear tendency among donor agencies to allocate more assistance to poor counties that have good economic governance. This contrasted with previous policies where aid was allocated on the basis of perceived need or other, possibly politically motivated, reasons, regardless of how corrupt or undeveloped the country's governance policies may have been. There is still an abundant amount of aid allocated based more on the purported "needs" of the donor country than the poverty levels of the recipient country. However, when aid is allocated based on poverty, the level of development of the country's institutions and policies is becoming increasingly important.

Ireland, McGregor, and Saltmarshe (2003) discuss some of the major changes occurring at donor agencies. Donor agencies are increasingly concerned with the effectiveness of their assistance programs and many have instituted "results-based" approaches to assistance. Ireland, McGregor, and Saltmarshe (2003) examine the policies of donor agencies and review the relevant literature and identify four common areas of concern that have emerged as agencies institute performance assessment; ownership, decentralization and leadership, accountability, and learning and complexity. They conclude that performance assessment takes place in a very complex environment, an environment often made more complex by the agencies themselves. Effective performance assessment is very difficult given the inherent complexity created by the large number of stakeholders and the additional agency-created complexity.

Alesina and Dollar (2000) found that foreign aid is "dictated as much by political and strategic considerations, as by the economic needs and policy performance of the recipients. Colonial past and political alliances are major determinants of foreign aid." However, they did find that countries that were more democratized received more aid, everything else being equal. They also looked at the flow of direct investment and found that "good policies" and the protection of private property rights were crucial to foreign investors.

Alesina and Weder (2002) found evidence that less corrupt governments do not receive more foreign aid than corrupt governments. This finding held for bilateral, multilateral, and individual donors, although evidence indicated that some individual donors, primarily Scandinavian countries, were more selective and gave less to more corrupt countries. In fact, their study showed that increased aid leads to increased corruption.

White (2004) reviewed trends in official flows to developing countries over three decades. He found that real aid levels declined in the 1990's and that the aid that was given has moved increasingly from the poorer countries, especially sub-Saharan Africa, and is driven more by political reasons. European donor countries appear to be donating more to European recipients, and aid in general is flowing more to areas where individual donors have a perceived interest, whereas multilateral donors still focus more on countries that appear to be more in need of assistance. Although the evidence is mixed, there does appear to be a growing recognition that need-based aid might be more effective in areas that are less corrupt and have more developed institutions. Many donors, especially multilateral donors like the World Bank are beginning to view corrupt, totally undeveloped countries as "rat holes" where money will simply disappear.

Additional evidence of this new "ideal" in the granting of aid is provided by the Key Principles of the Millennium Challenge Corporation (MCC). In January 2004, Congress passed a "new compact for global development" called for by President Bush which links greater contributions from developed nations to greater responsibility from developing nations. The President proposed a concrete mechanism to implement this compact -- the Millennium Challenge Account (MCA) - in which development assistance would be provided to those countries that rule justly, invest in their people, and encourage economic freedom.

Key Principles

Reduce Poverty through Economic Growth: The MCC will focus specifically on promoting sustainable economic growth that reduces poverty through investments in areas such as agriculture, education, private sector development, and capacity building.

Reward Good Policy: Using objective indicators, countries will be selected to receive assistance based on their performance in governing justly, investing their citizens, and encouraging economic freedom.

Operate in Partnership: Working closely with the MCC, countries that receive MCA assistance will be responsible for identifying the greatest barriers to their own development, ensuring civil society participation, and developing an MCA program. MCA participation will require a high-level commitment from the host government. Each MCA country will enter into a public Compact with the MCC that includes a multi-year plan for achieving shared development objectives and identifies the responsibilities of each partner in achieving those objectives.

Focus on Results: MCA assistance will go to those countries that have developed well-designed programs with clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for effective monitoring and objective evaluation of results. Programs will be designed to enable progress to be sustained after the funding under the MCA Compact has ended (http://ww.mca.gov, 2005).

This new awareness of aid effectiveness and the new guidelines for need-based foreign aid have arisen primarily because of research that has shown that aid is more effective in countries with more developed institutions and policies. In a review of the effects of aid on recipient nations, Burnside and Dollar (1997, 2004) concluded that there is broad agreement that aid does not have the same effect on all recipients. They specifically investigated the role that the quality of state institutions and policies has on the effectiveness of aid. They present evidence that aid spurs growth much more strongly in countries where the quality and integrity of institutions and policies is more developed. They also concluded that in the past, aid has not systematically led to improvements in institutions and policies. They argue that this might change in the future if aid is allocated more to countries with more developed institutions and policies.

The work of Burnside and Dollar (1997) has not been well-received by some. Easterly (2003), Hansen and Tarp (2000), and Dalgaard and Hansen (2000) among others, have all been critical. Easterly (2003) criticized the methodology used by Burnside and Dollar (2000) and attempted to show that their results were somewhat contrived and did not hold up consistently. Dalgaard and Hansen (2000) find that while good policies spur growth they may at the same time lead to decreasing effectiveness of foreign aid. They also contend that the econometric results obtained in Burnside and Dollar (1997) are fragile and extremely dependent upon the data set used. Burnside and Dollar (2004) used the same methodology as their earlier work, but with a larger and improved data set, to refute the criticisms and illustrate the robustness of their results.

Durbarry, Gemmell, and Greenaway (1998) investigated the effects of foreign aid using a variety of econometric techniques and found that foreign aid inflows have a beneficial effect on the growth rates of economies in lesser developed countries, but only when the countries had stable macroeconomic policies. Their results also suggested that there was an optimal level of aid and that too little or too much aid could actually have little positive effect.

Research by Banerjee and Rondinelli (2003) was designed to discover whether or not increased foreign aid led to an increase in the privatization of state-owned enterprises in developing countries. The process of privatization is being increasingly viewed as a key factor in the economic growth in less-developed countries. Their research revealed no direct relationship between aid and privatization and concluded that it was fundamentally a political decision based on the assessment of local government leaders concerning the political benefits of such a change in policy. However, their research did find “robust evidence of foreign aid playing a constructive role in privatization in the presence of superior governance structures.”

A very interesting result was obtained by Kosack (2003) in research aimed at determining if aid given to democratic countries was more effective in improving the quality of life of its citizens than aid given to autocracies. Kosack concludes that while aid in general has been shown to be ineffective, aid given to democratic countries does ameliorate the quality of life of its citizens. He attributes this to a general tendency of democracies to treat their people well, or at least better than autocracies. His results showed that economic aid can actually be harmful in autocracies in that the well being of citizens actually is worse off than if aid had not been given at all. A possible cause of this problem in autocracies is that aid money is spent to increase the advantage that the ruling parties have over the citizens of the country, an advantage which they feel is crucial if they are to remain in power.

Dollar and Kraay (2002) find that economic growth does not positively affect the poorest one-fifth of a country in a disproportionate manner. The poor benefit at the same rate as the rest of the country when economic growth occurs. The income of the poorest fifth of society increases with the average income of the nation. They also found that "a variety of pro-growth macroeconomic policies, such as low inflation, moderate size of government, sound financial development, respect for the rule of law, and openness to international trade, raise average incomes with little systematic effect on the distribution of income." They do not rule out the possibility that their methodology may not be able to capture the small marginal changes that some policies might have on the income of the poorest quintile, but in general conclude that at a minimum, the poorest citizens of a nation benefit just as much as everyone else when economic growth occurs. Thus, if economic aid can be structured to effectively help economic growth, then the poor should benefit in at least a proportional manner with the rest of the country.

DATA AND METHODOLGY

Gini coefficients are commonly used as a measure of income inequality. A Gini index value of zero indicates perfect income equality and, at the opposite extreme, a Gini index value of 100 indicates perfect income inequality. Since it is the goal of this research to explore the impact that financial aid has on the recipient nation's income inequality, we use as our dependent variable the change in the Gini index over a period of time. Ideally, the data used for this study would have consistent time frames for all countries included. However, Gini data is far from ideal. Deininger and Squire (1996) describe the problems with income inequality data and developed a "quality" data set that many researchers have utilized.

The income inequality data used in this study were taken from the database of Dollar and Kraay (2002), which draws upon four sources for the income inequality data including Deninger and Squire (1996), and the World Development Indicators (WDI) CD-ROM (2003). The countries selected had to have Gini indices spaced at least seven years apart. This would allow for a sufficient period of time to measure a change in income inequality. Also, the country had to be a recipient of Official Development Assistance (ODA). This was determined by the Aid Dependency Table (6.10) of the 2003 WDI Annual Report. The number of countries in the Dollar and Kraay (2002) data set with at least two Ginis with a seven year span and was a recipient of ODA was 66. These 66 countries were then analyzed based on their aid dependency. One measure that the World Bank uses as Aid Dependency is ODA as a percent of Gross National Income (GNI). This aid dependency ratio was then collected from the WDI CD-Rom over the 1980-2000 time period. The average over this time period was calculated and then ranked in descending order. The countries that had an average aid dependency ratio lower than 0.50% were omitted from the sample. The 0.50% cutoff was determined by Aid Dependency Table (6.10) of the 2003 World Development Indicators. In 1996 the average aid dependency ratio of low income countries was 2.5% and for middle income countries was 0.50%. Since the sample of countries used for this study included both low and middle income countries, the 0.50% was used as the cutoff. This left a sample of 44 countries. With this group of 44 countries, the next step was to start gathering other data that is used to control for certain aspects of the recipient nations' economy (population, GDP per capita, etc.) For these 44 countries, 15 countries did not have data going back to the 1980s. This led to the final sample of 29 countries.

Table 1 summarizes the data found for the 29 countries used in the study. It should be noted that the change in the Gini is actually the beginning Gini minus the ending Gini since this would lead to an intuitive interpretation. A lower Gini value indicates greater equality in income. For a country to show improvement in income inequality, the ending value of the Gini should have a lower value than the beginning Gini.

Table 1
Summary of Income Inequality Data

	Dates	Beginning Gini	Ending Gini	Change	Percent Change
Algeria	88/95	38.73	35.3	3.43	8.86%
Bangladesh	85/95	26.92	33.63	-6.71	-24.93%
Bolivia	90/99	42.04	44.70	-2.66	-6.33%
Botswana	85/93	54.21	63.00	-8.79	-16.21%
Cote d'Ivoire	85/95	41.21	38.00	3.21	7.79%
Dom. Rep.	89/96	50.46	48.71	1.75	3.47%
Ecuador	88/95	43.91	43.73	0.18	0.41%
Egypt	91/99	32.00	34.4	-2.40	-7.50%
El Salvador	89/98	48.96	50.8	-1.84	-3.76%
Ghana	87/97	35.35	32.70	2.65	7.50%
Honduras	86/96	54.94	53.72	1.22	2.22%
India	86/96	32.22	32.86	-0.64	-1.99%
Indonesia	87/96	32.01	36.48	-4.47	-13.96%
Jamaica	88/96	43.16	36.43	6.73	15.59%
Jordan	86/97	36.06	36.42	-0.36	-1.00%
Morocco	90/99	39.20	39.50	-0.30	-0.77%

Table 1 Summary of Income Inequality Data					
	Dates	Beginning Gini	Ending Gini	Change	Percent Change
Mauritania	88/95	42.53	38.90	3.63	8.54%
Nepal	84/95	30.06	38.78	-8.72	-29.01%
Nigeria	85/93	38.68	37.47	1.21	3.13%
Pakistan	85/96	32.44	31.20	1.24	3.82%
Panama	89/97	56.47	48.53	7.94	14.06%
Peru	85/94	45.72	44.87	0.85	1.86%
Philippines	85/94	46.08	45.07	1.01	2.19%
Paraguay	91/98	39.74	57.70	-17.96	-45.19%
Sri Lanka	85/95	32.47	34.36	-1.89	-5.82%
Thailand	86/96	47.40	40.45	6.95	14.66%
Tunisia	85/95	43.00	41.7	1.3	3.02%
Uganda	89/96	33.00	37.4	-4.4	-13.33%
Zambia	91/98	43.51	52.6	-9.09	-20.89%

Dates: The year for the beginning Gini index and ending Gini index
Change: Calculated as the beginning Gini index minus the ending Gini index (positive number indicates an improvement in the country's income inequality)
Percent Change: Change in the Gini divided by the beginning Gini

While foreign aid can take many forms, the aid measure used is Official Development Assistance. Official Development Assistance (ODA) is defined by the World Bank (WDI CD-ROM, 2003) as:

> Official development assistance and net official aid record the actual international transfer by the donor of financial resources or of goods or services valued at the cost to the donor, less any repayments of loan principal during the same period. Grants by official agencies of the members of the Development Assistance Committee are included, as are loans with a grant element of at least 25 percent, and technical cooperation and assistance.

Other measures of foreign aid have been used in the literature. Dalgaard and Hansen (2000) assessed the differences in alternative measures of foreign aid. They found that nominal ODA as a percent of GDP was highly correlated to alternatives such as real ODA (adjusted for purchasing power parity) and Effective Development Assistance of Chang, Fernandez-Arias, and Serven (1998). Dalgaard and Hansen (2000) found that, statistically speaking, there is little difference in alternative measures. Since we want to capture the effects of total aid dollars on income equality, ODA in current U.S. dollars is used (nominal ODA). The annual dollar amount of ODA is averaged from

1980-1989. The reason for measuring aid prior to the first Gini index is to allow for a time lag since aid will not have an immediate impact on income inequality. The time frame for the aid starts at a minimum of four years prior to the first Gini index.

The remaining variables used to explain the change in Gini and to control for various country specific conditions are provided in the appendix. This collection of potential explanatory variables stems from the past literature for income inequality and growth. For most variables with annual observations, an average is taken from 1985-1994. This ten-year window tends to correspond to the time period for which the change in the Gini is being measured. Table 2 shows the correlation matrix for all variables used in the study. There is very low correlation between the potential explanatory variables and the change in the Gini index. There are no correlations between any of the variables that are greater that 0.70. There are three correlations in the 0.60 to 0.70 range: population and ODA has a correlation of 0.69, fertility and enrollment in secondary school has a correlation of -0.63; and government consumption and trade has a correlation of 0.65.

Table 2
Correlations

	Change in Gini	Corrup	Fertility	For. Inv.	Free	GDP	GDP Gro.	Govt. Cons.	Ill.	Inf.	Land	ODA	Pop.	Sec.
Corruption	-0.013													
Fertility	-0.267	-0.118												
Foreign Inv.	-0.028	-0.19	0.026											
Freedom	0.088	-0.1	0.399	-0.005										
GDP	0.184	0.276	-0.502	-0.044	-0.293									
GDP Growth	-0.118	0	-0.210	0.045	-0.138	0.000								
Govt. Cons.	0.162	0.202	0.343	-0.016	0.287	0.283	-0.090							
Illiteracy	-0.059	0.03	0.572	-0.134	0.412	-0.575	0.029	0.196						
Inflation	-0.125	0.08	0.100	0.205	-0.167	0.069	-0.371	-0.204	-0.247					
Land	-0.360	-0.119	0.370	0.294	0.149	0.048	-0.090	0.254	0.012	0.191				
ODA	-0.098	0.041	-0.151	-0.138	0.000	-0.373	0.286	-0.138	0.312	-0.220	-0.349			
Population	-0.004	-0.066	-0.119	-0.155	-0.096	-0.294	0.268	-0.136	0.191	-0.133	-0.101	0.691		
Sec. School	0.227	0.244	-0.634	0.088	-0.254	0.503	-0.115	-0.026	-0.512	0.066	-0.386	0.096	0.020	
Trade	0.15	0.148	-0.020	0.236	0.060	0.469	-0.05	0.650	-0.278	-0.273	0.096	-0.406	-0.41	0.127

A variety of statistical approaches have been used in the literature for income inequality. Most of the focus on foreign aid has centered around its potential effects on economic growth. Within the growth literature, there are various growth models and production functions which specify the inputs, and researchers have explored a wide variety of econometric models. For income equality, there is no exact theoretical model to dictate what variables or methodologies are correct.

Without a theoretical model specifying the impact that foreign aid should have on income equality, the statistical approach is left to the researcher. Since the thrust of this research is to search for a causal relationship between foreign aid and changes in income inequality, ordinary least squares is used.

RESULTS

When hypothesizing the potential impact that foreign aid can have on the recipient nation's income inequality, there are three possible outcomes. First, foreign aid can lead to an improvement of income inequality. This would be indicated by a statistically significant positive coefficient for the aid variable. This is potentially the most desirable outcome from the standpoint that this would allow the conclusion that foreign aid benefits or improves the income inequality in recipient nations. This would also corroborate the Modernization Theory (Hoselitz, 1960), where assistance to developing countries expedites the development process.

Second, foreign aid has no impact on income inequality. This would be evidenced by a coefficient that was not statistically different from zero. While statistically this would mean no relationship between income inequality and foreign aid, this would not imply that foreign aid does not improve economic conditions or encourage growth of developing economies. Rather, that the benefits of aid are not directly related to improvement in income inequality.

The third possible outcome is that foreign aid has a negative impact on income inequality. If there is a statistically significant negative relationship between changes in income inequality and foreign aid, this would imply that recipients of aid were not made better off by receiving aid from an income inequality standpoint. We would not necessarily be able to say that the countries are in worse condition for having received aid but there would be evidence to indicate that foreign aid did not improve income inequality. Additionally, this outcome would lend support to the Dependency Theory (Amin, 1976; Frank, 1979) where the recipient nations become dependent on developed countries for trade and capital to the point where economic growth is impeded. If the Dependency Theory is correct, and foreign aid hurts economic growth it could also hamper efforts to improve income equality.

Table 3 reports the results of the regression analysis. This model encompasses all the potential explanatory variables. The variable that is statistically significant at the five percent level is arable land (average arable land per capita in hectares). ODA and government consumption are statistically significant at the ten percent level of significance. Arable land and ODA both have negative impacts on changes in income inequality and government consumption has a positive relationship. The adjusted R-squared (0.04) and F-statistic (1.09) for the regression model is very low since there are numerous variables included in the model that are not statistically significant. As far as the diagnostics for the regression results, the residuals are normally distributed, there is no hetroskedasticity, but there is evidence of serial correlation.

Table 3 **Regression Results** Model with all explanatory variables (Dependent Variable: Change in Gini)				
	Regression Coefficient	Standard Error	t-Statistic	P-Value
Constant	22.23574	13.451	1.653	0.121
Corruption	-0.168028	3.007	-0.056	0.956
Fertility	-2.790028	1.656	-1.684	0.114
Foreign Investment	2.483198	1.782	1.393	0.185
Freedom	0.621509	0.809	0.768	0.455
GDP	0.000159	0.003	0.059	0.954
GDP Growth	-0.765483	0.674	-1.135	0.275
Government Cons.	0.900801	0.448	2.008	0.064
Illiteracy	-0.035686	0.099	-0.360	0.725
Inflation	-3.171945	5.386	-0.589	0.565
Land	-28.81735	10.995	-2.621	0.02
ODA	-7.25E-09	0.000	-1.885	0.08
Population	1.03E-08	0.000	1.035	0.318
Secondary School	-0.119644	0.106	-1.126	0.279
Trade	-0.133668	0.098	-1.363	0.195
Regression Statistics:				
R-squared	0.521		F-statistic	1.089
Adjusted R-squared	0.043		Prob (F-statistic)	0.438
S.E. of regression	5.385		Durbin-Watson stat	2.379

In order to find a more parsimonious model, the redundant variable test was used to determine if variables could be omitted from the regression. Using this approach, freedom index, foreign investment, per capita GDP, GDP growth, illiteracy, inflation, population, and enrollment in secondary school could all be omitted. As these variables were omitted, the adjusted R-squared and the F-statistic improved. The best fit model is presented in Table 4. The adjusted R-squared is 0.20 and the F-Statistic is 2.39. The residuals are normally distributed with no hetroskedasticity or serial correlation. In this model, arable land and government consumption are significant at the 5% level and ODA is significant at the 10% level. While fertility and trade are not significant at the 10% level, their role in the model is still important since without these two variables, the model's explanatory power and validity is reduced. The relationship among the variables is perhaps more complex than is being captured through the model.

Table 4
Regression Results
Dependent Variable: Change in Gini

	Regression Coefficient	Standard Error	t-Statistic	P-Value
Constant	8.529097	5.237	1.629	0.117
Fertility	-1.539249	0.902	-1.706	0.102
Government Cons.	0.606070	0.289	2.096	0.047
Land Use	-18.09975	7.522	-2.406	0.025
ODA	-4.41E-09	0.000	-1.768	0.090
Trade	-0.070857	0.059	-1.201	0.242
Regression Statistics:				
R-squared	0.342		F-statistic	2.392
Adjusted R-squared	0.199		Prob (F-statistic)	0.069
S.E. of regression	4.926		Durbin-Watson stat	2.299

Given the results in Table 4, there are some interesting findings. Arable land is statistically significant and has a negative coefficient. The more arable land a country has the more likely that income inequality will worsen over time in the presence of other variables being constant. This provides evidence for the theory that natural resources can be a curse. As explained in Sachs and Warner (2001), countries with abundant natural resources tend to grow more slowly than resource-poor countries. They conclude that resource-rich countries miss opportunities for export-led growth. Government consumption has a positive relationship with improvement of income inequality. This indicates that government spending does improve income inequality. Foreign aid has a negative impact on income inequality. As discussed earlier, a negative relationship indicates that, from an income inequality view, recipient nations are worse off from receiving aid. Again, it does not imply aid is not beneficial in other aspects, but given our results it lends some credence to the Dependency Theory. It is also interesting to note the variables that are not statistically significant in explaining changes in income inequality. For these 29 countries, measures for the countries' political policies (freedom index and corruption index), economic conditions (foreign investment, GDP per capita, GDP growth, and inflation), and human capital (illiteracy and enrollment in secondary school) were not able to explain changes in income inequality.

The conclusions of the study must be interpreted with caution since the statistical results appear to be somewhat fragile. As different variables were omitted from the regression, the significance but not the sign of ODA changed. To explore this issue further, two alternative specifications of the aid variable (ODA) were substituted in the above analysis. First, ODA as a ratio of each country's GDP was substituted in the model. This is the most common measure of aid utilized in the literature. The results did not show a significant statistical relationship (p-value = 0.1642) between aid and changes in income inequality. Second, instead of using a consistent time frame for measuring ODA across the 29 countries, we matched up the time frames with the Gini index. Under this specification, ODA in current U.S. dollars was still used but the average for ODA was calculated using ODA five years prior to the first Gini through five years prior to the second Gini. For this specification, the results did not show any statistical relationship between aid and changes in income inequality at the ten percent level (p-value = 0.1037). In two specifications of aid, we do not find a statistically negative relationship at the 10 percent level of significance but for our original specification, a negative relationship exits.

CONCLUSIONS

The results of the statistical analysis indicate that arable land, government consumption and foreign aid are all important variables in explaining changes in income inequality. Both arable land and foreign aid have a negative relationship with changes in income inequality, while government consumption has a positive relationship. Our results provide evidence of foreign aid ineffectiveness for recipient nations and that foreign aid negatively impacts changes in income equality over time. Also of interest are the variables that were not found to be significant predictors, such as political rights (freedom index), perceptions of the county's level of corruption (corruption index), economic factors (inflation and economic growth), and human capital (illiteracy and secondary school enrollment).

An area for future research would involve further investigation of the institutions and policies for the recipient nations. Burnside and Dollar (2004) found that foreign aid is beneficial for growth in recipient nations that have sound institutions and policies. While their results have been debated, the importance of quality institutions and policies should be explored further. In our attempts to measure this, we used corruption index, freedom index, and foreign investment could also be used as an indirect indicator of a country's management. Our measures of quality institutions and policies did not prove to be significant in explaining changes in income inequality. It may be that the indicators used are not adequate or that the relationship is too complex to capture in simple regression models. Also, more work needs to be conducted on the alternative measures of foreign aid since our results suggest that aid definitions may impact the overall outcome of the role that foreign aid has on income inequality in recipient nations.

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APPENDIX: VARIABLE DEFINITIONS AND SOURCES		
Variable	Comments	Source
Gini Index	0 indicates perfect equality and 100 indicates perfect inequality	Dollar and Kraay (2002) and World Development Indicators CD-ROM (2003)
Change	Change in the Gini Index	Calculated
Corruption	Corruption Perception Index (0=most corrupt and 10=corruption free) for 1996	www.icgg.org
Fertility	Average Fertility Rates (total births per woman) for 1985, 1987, 1990, and 1992	World Development Indicators CD-ROM (2003)
Foreign Investment	Average net inflows of foreign direct investment as a percent of GDP from 1985-1994	World Development Indicators CD-ROM (2003)
Freedom	Average of Political Rights Freedom Index (1=highest degree of freedom and 7=lowest) from 1985-1994	Freedom House
GDP	Average GDP per capita in constant 1995 dollars from 1985-1994	World Development Indicators CD-ROM (2003)
GDP Growth	Average growth rate in GDP from 1985-1994	World Development Indicators CD-ROM (2003)
Government Consumption	Average government consumption as a percent of GDP from 1985-1994	World Development Indicators CD-ROM (2003)
Illiteracy	Average adult illiteracy rate from 1985-1994	World Development Indicators CD-ROM (2003)
Inflation	Natural log of 1+average inflation rate (CPI) from 1985-1994 for some countries, the average is for the inflation that is available over this time period	World Development Indicators CD-ROM (2003)
Land	Average arable land per capita (hectares) from 1985-1994	World Development Indicators CD-ROM (2003)
ODA	Average Official Development Assistance in U.S. dollars from 1980-1989	World Development Indicators CD-ROM (2003)
Population	Average total population in thousands from 1985-1994	World Development Indicators CD-ROM (2003)
Secondary School	Ratio of total enrollment in secondary school, regardless of age, to the population of the age group that officially corresponds to the level of education shown. The average is taken over 1990-1994.	World Development Indicators CD-ROM (2003)
Trade	Sum of exports and imports of goods and services measured as a percent of gross domestic product. Average over 1985-1994	World Development Indicators CD-ROM (2003)

THE EMERGING LANDSCAPE OF TRADE LIBERALIZATION AND NON-UNIFORM CHINA EFFECTS UNDER THE WTO REGIME

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ABSTRACT

Within the context of economic globalization and emerging WTO-related trade conflicts, the present study examines the ongoing debates over China's accession to the World Trade Organization (WTO) from three perspectives: major opportunities and challenges from China's perspective, counterpoints from the United States' perspective, and prospective impacts from the global perspective. Results indicate that the China effect under the WTO regime will not be uniform globally; neither will it be equally beneficial to the Chinese. Suggestions for future research and implications for policy making are provided.

INTRODUCTION

This study examines the complexity and ongoing debates about the China effect associated with China's economic growth and trade liberalization. The rising China effect is analyzed from three perspectives: (1) major opportunities and challenges from China's perspective, (2) counterpoints from the United States' perspective, and (3) prospective impacts from the global perspective. Critical issues analyzed include China's fast growing economy and trade position in the world, the accelerating disparate distribution of welfare and associated problems within China, the emerging redistribution of the worldwide foreign direct investment (FDI) under the WTO regime, and conflicting ideas about the WTO and trade liberalization raised by various interest groups from the West, particularly from the United States. Results indicate that China's WTO membership may dramatically reshape the landscape of world trade by engendering two major waves. First, as the United State and the European Union normalize their trade relationships with China, China's exports will compete forcefully with other export-driven economies, intensifying low-cost commodity competition among developing nations in the Western marketplace. Second, as China lifts quotas and non-tariff mechanisms that have protected Chinese farmers and domestic industries, foreign capital will increasingly beat a path to enter the Chinese market, leading to accelerated foreign competition in various economic sectors within China, particularly in agriculture, financial services, and traditional industries such as chemical, petroleum, steel, machinery, and automobile. Thus the China effect will not be uniform globally. Neither will it be equally beneficial to the Chinese.

It is under those circumstances that the present study reviews the china effect from multiple perspectives, particularly to address the impact of globalization and to weigh conflicting ideas associated with free trade and social justice. The primary purpose of the study is to gain a better understanding of international trade concepts and practical challenges in the increasingly intertwined world, so that to generate suggestions for future research and implications for policymaking.

CHINA'S ECONOMY AND TRADE POSITION IN THE WORLD

Over the past decade, the world economy has been growing fastest in East Asia and the Pacific Rim, averaged 7.3% annually (World Bank, 2004). Leading this growth is China's emerging market economy with an impressive annual growth rate of its gross domestic product (GDP) around 8-10%, while the world economy grew by approximately l.9% in 2002. With more than two decades of economic reform, China has built up a solid track record of shifting toward a more open and market-oriented economy. According to the World Bank (2001), China's annual economic growth has averaged around 8% for the past two decades, quadrupling its GDP since 1978. The World Development Indicators (World Bank, 2001) have ranked China the seventh largest leading exporter (3.9%) and eighth largest leading importer (3.4%) of the world's merchandise trade. For commercial services, China has ranked as the twelfth leading exporter (2.1%) and tenth leading importer (2.5%) around the world. Most recently, China has moved up to become the sixth largest economy in the world, with trade in goods accounting for 49% of its GDP (World Bank, 2004). By the end of 2003, China's total foreign reserves reached US$410 billion and further surged to US$440 billion by March 2004. Table 1 summarizes China's top ten trade partners in the global market in 2003. Data show that China's total trade with these trade partners increased approximately by 26% to over 50% from 2002 to 2003.

It is estimated that the China effect will raise the world economic growth by a quarter percentage point in the next decade (Einhorn, Dawson, & Kunii, 2001). China's WTO debut, however, is not uniformly good news to the world. On the one hand, for example, Western farmers will win big from China's pledge to sharply limit import barriers on wheat, corn, rice, and other agricultural commodities, which could boost China's food imports by US$73 billion over ten years. Already, prior to China's WTO membership, American farm and food exports to China reached US$1.7 billion in 2000, making China the seventh largest market for U.S. farmers and food industries (Baculinao, 2001). On the other hand, as the United States and the European Union lift their last restraints on China's textile products, Mexico and the Caribbean markets could lose thousands of garment-industry jobs to China within foreseeable years. At a time when most emerging markets are desperate for foreign capital, increased FDI is flowing to China. Multinational corporations such as Intel, Motorola, and Dell computers are already moving production to China.

Foreign car makers such as General Motors, Ford, Volkswagen, Honda, and Toyota will launch new cars aimed at quality- and cost-conscious Chinese consumers, and set up nationwide dealerships and service networks (Roberts & Webb, 2001). Table 2 highlights China's FDI growth after joining the WTO. China's strong FDI inflows reflect the increased market opening required by China's WTO membership, new opportunities related to preparations for the 2008 Beijing Olympics, and the government's push to build up the nation's infrastructure. Investors are shifting production facilities from other Asian counties to China while China is experiencing an influx of supplies of intermediary goods.

Table 1
China's Top 10 Trading Partners (Total Trade, US$ million)

Country	2003	% Change	Rank
Japan	133573.4	31.1	1
United States	126334.4	30	2
Hong Kong	87407.7	26.3	3
South Korea	63231.1	43.4	4
Taiwan	58367	30.7	5
Germany	41876.3	50.7	6
Malaysia	20127.8	41	7
Singapore	19352.3	37.9	8
Russia	15760.6	32.1	9
Netherlands	15438.7	44.6	10

Source: Adapted from PRC General Administration of Customs, *China's Customs Statistics,* 2004

Table 2
China's FDI Growth (2001-2003)

FDI Status	2001	2002	% Change	2003	% Change
Number of Projects Approved	26139	34171	30.7	41081	20.22
Contracted Investment (US$ billion)	69.19	82.77	19.6	115.07	39.03
Utilized Investment (US$ billion)	46.86	52.74	12.5	53.51	1.44

Source: Adapted from PRC Ministry of Foreign Trade and Economic Cooperation, 2004

China's competitive advantages in the global economy include abundant cheap labor, millions of well-trained yet relatively low-paid engineers, and good infrastructure. Transportation from China to the key U.S. markets is faster than from some other markets in Asia. For example, shipment time from China to California takes 14 days as compared to 30 days from Sri Lanka. The total length of China's road transportation is ranked fourth in the world, about 1.7 million kilometers including quality highway transportation for about 20,000 kilometers (Han, 2002). Thus, China's arrival as a manufacturing superpower along with its huge domestic market could reshape the landscape of world trade dramatically in a foreseeable future, but the China effect will not be uniform for all parties concerned.

Table 3
Prospective Global Impacts of China's WTO Membership

Markets	Prospective China Effects
North America	Farmers will get a new market for agricultural and food products. Semiconductor, telecom-gear, and computer makers will get duty-free access to China.
United States	More trade and investment opportunities will reveal in agriculture, semiconductor, telecom, pharmaceuticals, automobile, and financial services, with growing trade deficits with China as China takes over some trade business from Japan, South Korea and some other economies.
Mexico	Garment and shoe industries will be hit hard as quotas limiting Chinese exports to the U.S. are lifted
European Union	Imports of Chinese shoes, dishes, and kitchen utensils will rise as the EU phases out quotas. More FDI will flow from EU countries to China as China liberalizes the market under WTO. Already, China is the third most important non-European trade partner for the EU, and EU ranks the second for China's imports and third for China's exports. By 2005, EU is likely to become China's number one trading partner.
Japan	Imports of a wide array of consumer goods will grow as more Japanese manufacturers shift production to China-based suppliers. Equipment, vehicle, and electronics exports will rise. Significant Japanese exports will be shift from the U.S. market to China.
South Korea	Exports of fabrics to China's surging apparel industry could swell, as could outflow of industrial gear and high-grade steel.
Taiwan	Its $16 billion trade surplus with mainland China will fall. More production will go to China, boosting competitiveness of Taiwan tech industries as well as reallocation of Asia-based FDI.
Southeast Asia	Thailand, the Philippines, Indonesia, and Malaysia will lose FDI to China. Pressure will grow to upgrade industries and workforces.

Source: Based on Asia's Future, *BusinessWeek*, October 22, 2001; EU Commission, 2004; *U.S.-China Business Council Statistics*, 2004; *World Bank Statistics*, 2004.

Since joining the WTO in November 2001, China has been a locomotive for the economic growth in Asia and the Pacific Rim. By 2003, China's open market accounts for 18% of South Korea's exports, 12% of Japan's exports, and about 6-7% of the total exports of the ASEAN countries (Association of Southeast Asian Nations). China is now the third most important non-European trade partner for the European Union (EU), following the United States and Japan. The EU is ranked second for China's imports, after Japan, and third for China's exports, after the United States and Japan. It is forecasted that by 2005, the EU is likely to become China's number one trade partner, displacing the United States and Japan (Murphy, 2004). While China represents just 3% of the world GDP, its rapid economic growth will account for 10-15% of any expansion of the global economy in years to come (Roberts, Einhorn, Fairlamb, Ihlwan, & Byrnes, 2004). Table 3 highlights some prospective global impacts of the China effect under the WTO regime.

Clearly, China's booming economy has significant impacts beyond its borders. China's current effort to engineer a soft landing in order to cool down the economy will generate significant repercussions to the rest of the world. For example, a 10% reduction in the growth of China's imports could result in a loss of about 1% GDP growth in South Korea and Taiwan (World Bank, 2004). At the same time, China must balance the need to continue creating jobs and reforming the economy while keeping the economy stable and slowing down excessive investment. China's continued prosperity and stability will influence economic fortunes elsewhere. The effects of China's soft landing, however, remain to be seen.

A HISTORICAL OVERVIEW OF CHINA'S ACCESSION TO THE WTO

The World Trade Organization originated as the General Agreement on Tariffs and Trade (GATT) signed by 23 nations in 1947. The most favorable nation (MFN) clause calls for each member nation to grant every other member nation the most favorable treatment concerning imports and exports. However, GATT had no intention of becoming an enforcement mechanism, but virtually relied on moral suasion. With the increasingly large membership and the growing need for market discipline based on agreed upon rules and terms among the member nations, on January 1, 1995, GATT was supplanted by the WTO with three main purposes: (a) to help trade flow as freely as possible as long as there are no undesirable side effects, (b) to serve as a forum for trade negotiations, and (c) to settle disputes through neutral procedures based on an agreed legal foundation.

Retrospectively, China was an original signatory of GATT, but the Nationalist government on Taiwan withdrew China's membership in 1949. The People's Republic of China applied to resume China's status as a contracting party of GATT in 1986. As GATT turned into the WTO, China requested conversion of the Working Party on China' status as a contracting party to full membership of the WTO. On November 10, 2001, the WTO members unanimously voted to admit China, and on the following day, Taiwan joined the WTO as well. Long Yong-tu, Head of the

Chinese delegation described the negotiation, which took 15 years to conclude, as "long", "painstaking", and with "numerous difficulties and frustrations" (Long, 2001). Pascal Lamy, the EU Trade Commissioner viewed the decision to welcome China into the WTO as "historical", "the WTO's greatest leap in the history of the organization", and the 15 years of negotiation as "long and arduous" and as also "the history of China's reform process, its gradual opening-up, and its integration into the world economy" (Lamy, 2001).

In welcoming China, the WTO has expanded the membership by 1.2 billion people that is to say by a quarter. From GATT to the WTO, the international body today has grown to include 147 members. Mike Moore, the WTO Director-General maintains that with China's accession, the near universal acceptance of the WTO rules-based system will serve a pivotal role in underpinning global economic cooperation (Moore, 2001).

Table 4
The United States' Top Ten Trading Partners (2003, US$ million)

Country	U.S. Exports	U.S. Imports	Subtotal	Balance	Rank
Canada	169769	224165.3	393934.3	-54396.3	1
Mexico	87457.3	138073.5	225530.8	-40616.2	2
China	28418.5	152379.1	180797.6	-123960.6	3
Japan	52063.7	118029	170092.7	-65965.3	4
Germany	28847.9	68074.1	96922	-39199.2	5
United Kingdom	33895.7	42666.9	76562.6	-8771.2	6
Korea, South	24098.6	36963.3	61061.9	-12864.7	7
Taiwan	17487.9	31599.9	49087.8	-14112	8
France	17068.2	29221.2	46289.4	-12153	9
Italy	10596.9	25463.6	36060.5	-14866.7	10

Source: Adapted from *U.S. Census Bureau Statistics*, 2004. Total may not add up exactly due to rounding.

COUNTERPOINTS FROM THE U.S. PERSPECTIVE

Despite China's continuous effort to open up to the outside world and its growing penetration into the global marketplace, China's accession to the WTO has caused heated debates in the West as well as within China. Many, at least from the Chinese perspective, consider the negotiation with the United States as extremely difficult and frustrating. From the United States' perspective, major issues of high controversy include the growing trade deficits between the two countries, human rights and environmental concerns within China, and job losses in the United States. Table 4 lists the world's top ten trade partners with the United States. According to the U.S. Census Bureau

(2004), these trade partners represent about 68.5% of U.S. imports, and 65.9% of U.S. exports in goods. While each of these top ten trade partners has contributed to the U.S. overall trade deficit, notably, China has exceeded Japan to represent the largest portion of the U.S. trade deficit since 2000. Until November 2001, China and Taiwan were the only two major U.S. trade partners not in the WTO. Tables 5 and 6 list the world's top exporters and importers with the United States. According to the U.S. Census Bureau statistics (2004), China is ranked the second largest exporter and the fifth largest importer for the United States.

Table 5
The World Top 15 Exporters for the United States (2004, US$ billion)

Country	Exports to the U.S.	Percent of Total	Rank
Canada	255.9	17.4%	1
China	196.7	13.4%	2
Mexico	155.8	10.6%	3
Japan	129.6	8.8%	4
Germany	77.2	5.3%	5
United Kingdom	46.4	3.2%	6
South Korea	46.2	3.1%	7
Taiwan	34.6	2.4%	8
France	31.8	2.2%	9
Malaysia	28.2	1.9%	10
Italy	28.1	1.9%	11
Ireland	27.4	1.9%	12
Venezuela	25	1.7%	13
Brazil	21.2	1.4%	14
Saudi Arabia	20.9	1.4%	15
Subtotal of Top 15 Countries	1125.1	76.5%	-
Total of All Countries	1471	100.0%	-

Source: Adapted from *U.S. Census Bureau Statistics*, 2004.

While American firms expand businesses across borders, so are their foreign competitors. The U.S. domestic market is flooded with foreign made products. Among the U.S. opponents are the labor unions such as AFL-CIO (American Federation of Labor and Congress of Industrial Organizations) and numerous NGOs (nongovernmental organizations) for human rights, fair trade, and environmental protection (Nolt, 1999). The growing U.S. trade deficit with China often assumes center stage in debates about the trade relationship between the two countries. Table 7 summarizes the U.S. trade balance with China for the past five years. Although the U.S. International Trade Commission (1999) estimated that China's accession to the WTO could increase U.S. exports by 10.1%, and imports from China by 6.9%, critiques maintain that the absolute deficits would continue to grow. Major concerns over the China-WTO deal suggest spiraling trade deficits, job losses, and deepening income inequality in the U.S. (Scott, 2000).

Table 6
The World Top 15 Importers for the United States (2004, US$ billion)

Country	Imports from the U.S.	Percent of Total	Rank
Canada	190.2	23.2%	1
Mexico	110.8	13.5%	2
Japan	54.4	6.6%	3
United Kingdom	36	4.4%	4
China	34.7	4.2%	5
Federal Republic of Germany	31.4	3.8%	6
Korea, South	26.3	3.2%	7
Netherlands	24.3	3.0%	8
Taiwan	21.7	2.7%	9
France	21.2	2.6%	10
Singapore	19.6	2.4%	11
Belgium	16.9	2.1%	12
Hong Kong	15.8	1.9%	13
Australia	14.3	1.7%	14
Brazil	13.9	1.7%	15
Subtotal of Top 15 Countries	631.4	77.1%	-
Total of All Countries	819	100.0%	-

Source: Adapted from *U.S. Census Bureau Statistics*, 2004.

Advocates champion the belief that China's accession to the WTO will benefit many major U.S. industries, and U.S. consumers will win ultimately from the low cost commodities made in China. China's low cost products also help keep the U.S. inflation rate low. Among American producers likely to gain the most are U.S. farmers, financial companies, and high-tech industries. China's concessions in the financial sector are the most profound because they benefit not only U.S. banks and insurance companies but also other U.S. exporters and investors as U.S. financial service companies assist them as well as their Chinese customers. As new sectors of the Chinese economy are opened, U.S. export opportunities will increase work and subsequently create more job opportunities for Americans in industries such as aerospace, chemicals, entertainment, computers, waste treatment, biotechnology, telecommunications equipment, medical equipment, and other high tech products. Tables 8 and 9 list top ten U.S. exports to and imports from China in 2002 and 2003, indicating significant merchandise trade increases in both directions.

Table 7
Recent History of the U.S. Trade Balance with China (US$ billion)

U.S.	1999	2000	2001	2002	2003	2004
Exports	13.1	16.2	19.2	22.1	28.4	34.7
Imports	81.8	100.2	102.3	125.2	152.4	196.7
Balance	-68.7	-83.8	-83.1	-103.1	-124	-161.9

Source: Adapted from *U.S. Census Bureau Statistics*, 2004. Total may not add up exactly due to rounding.

Table 8
Top U.S. Exports to China (US$ million)

HTS #	Commodity Description	2002	2003	% change
85	Electrical machinery & equipment	3950.1	4782.6	21.1
84	Power generation equipment	4109.1	4639.6	12.9
12	Oil seeds & oleaginous fruits	917.9	2877.4	213.5
88	Air & spacecraft	3428.8	2451.2	-28.5
90	Medical equipment	1258.6	1594	26.6
39	Plastics & articles thereof	995.2	1247.5	25.4
72, 73	Iron & steel	591.1	1213.9	105.4
29	Organic chemicals	619.9	1105.3	78.3
52	Cotton	153.4	769.3	401.6
74	Copper	319.6	652.3	104.1

Source: US International Trade Commission, US Department of Commerce, 2004.

OPPORTUNITIES AND CHALLENGES FROM CHINA'S PERSPECTIVE

Although China's gross national income is one of the largest in the world, ranked sixth, its per capita income is among the lowest, ranked 136th in 2002 (World Bank, 2004), which, however, was significant progress from its 142nd position in 2001. Concerns over China's WTO membership are not just its prospective economic and trade-related impacts globally but also the increasing disparate distribution of welfare and lack of workers' protection within China. While many Chinese have benefited from the economic reform, and about 100 million have joined the middle class, which means earning at least US$2,500 a year, millions more are slipping into a new underclass of displaced peasants, unemployed or underemployed factory workers, and low-level laborers whose wages barely sustain them (Einhorn, et al. 2001). Agricultural sectors, heavy industries, and small scale producers of fertilizers, steel, cement, motorcycles, and farm machines, in which China is not a competitive producer, will suffer in two ways: directly from increased foreign competition, and indirectly from losing capital to more lucrative sectors.

Table 9
Top U.S. Imports from China (US$ million)

HTS #	Commodity Description	2002	2003	% change
84	Power generation equipment	21070	31039.8	47.3
85	Electrical machinery & equipment	25408	30043.1	18.2
95	Toys & games	15491	17399.9	12.3
94	Furniture	11225.6	13670.4	21.8
64	Footwear & parts thereof	10763.1	11144.8	3.5
61, 62	Apparel	7473.5	9156.8	22.5
42	Leather & travel goods	4782.8	5440.6	13.8
39	Plastics & articles thereof	4144.3	4779.9	15.3
72, 73	Iron & steel	3094.4	3855.5	24.6
90	Medical instruments	2874	3386.9	17.8

Source: US International Trade Commission, US Department of Commerce, 2004.

A major concern over the dark side of economic globalization is the deepening gap between the rich and poor and the increasing challenge of the world poverty problem. In the case of China, about 90% of the poor live in the rural areas (World Bank, 2004), while China's WTO accession could easily mean a 3% reduction in per capita farm income (Baculinao, 2001). Some 70-100 million poorly educated villagers are roaming the cities for job opportunities. About 60% of those farmers fail to find city jobs and eventually have to return home or become homeless. Alarmingly, there has been steady drop in farm acreage across the country due to non-farming commercial use and some weather-related events, resulting in a 5.8% drop in grain output. In 2003 alone, China's total arable land shrank by 4.3%, proving a lightning rod for the government's new announcements regarding the safeguarding of land for grain production (World Bank, 2004). On the one hand, China's entry into the WTO would mean an increase of US$2 billion in U.S. agricultural exports to

China. The U.S. Department of Agriculture has estimated that China's WTO membership would potentially add US$1.6 billion by 2005 to the annual total of U.S. exports of grains, oilseeds products and cotton (Baculinao, 2001). On the other hand, given that China's urban unemployment has been rising due to the ongoing reform and downsizing of state-owned enterprises, the massive numbers of surplus laborers from rural areas remain a big challenge to the long-term socioeconomic stability. China's urban unemployment has been growing as the economy restructures and organizations implement layoffs. The urban unemployment rate is estimated as high as 15%, way above the official figures of just over 4% (Roberts, et al. 2004). As rural poverty remains high and rural-urban income and non-income disparities continue to widen, a stronger emphasis on growth with equity has become increasingly critical. Industrial sectors that will gain directly from China's accession to the WTO include textile, clothing, toy, food processing, and other simple consumer products, but they only constitute a small fraction of the total economy. The growth of jobs in those sectors may not be rapid enough to counteract the fall of employment in less competitive sectors. Meanwhile, under pressure from international competition that pushes the urban economy to shift toward more capital- and technology-intensive sectors, the number of jobs created by a given economic growth will decline. This pressure could be exacerbated under the WTO regime.

Underlining China's current strategic efforts for long-term prosperity and socioeconomic changes are three key dimensions: modernization, urbanization, and globalization, all of which are forces driving towards both convergence and divergence in the distribution of the nation's wealth and economic opportunities.

DISCUSSION AND CONCLUSION

Integrating China into the global economy is a major policy challenge for both China and the rest of the world. With continuous economic transformation and a rapid annual GDP growth, China is becoming a major international trading power, but the prospective impacts of China's WTO membership will not be uniform globally. Neither will it be equally beneficial to the Chinese. In a comparative study on the impact of globalization of the world economy, Sassen (1991) illustrates that the process of globalization has led to division of the workforce into specialized high-salary work and low-wage support services across cultures. Similarly across cultures, large segments of urban populations have been pushed to marginal employment, which should concern both developed and developing countries. Policy makers as well as business organizations should be aware of major challenges and potential tradeoffs associated with economic globalization and trade liberalization. In the case of the complex China effect in the world economy, several issues examined in this study merit further research attention and have important implications to the practical field.

First, rapid socioeconomic changes in China and China's further integration into the world community have highlighted both opportunities and challenges. For example, while remaining a developing country, China's booming economy and huge domestic market has become a locomotive for the world economic growth, and will continue to generate more trade, FDI, and commercial cooperation between China and the rest of the world. People in China are on average four times as wealthy today as they were in 1978, when the open door policy was just started (Lamy, 2001). Along with the socioeconomic changes, however, there are emerging problems such as the widening rural-urban income and non-income disparities, the growing unemployment rate and pressure to create more jobs in order to maintain the long-term social stability, the underfinanced social security systems, the ill-managed banking and financial systems, and the deteriorating environment including the arable land loss and deforestation. These issues call further studies on globalization, socioeconomic justice, and corporate social responsibility in and beyond China. An increasing stress on unequal distribution of power and welfare, labor's rights, and environment concerns will force such critical issues into laws and regulations as pertaining to pension reform, housing, health care, unemployment compensation, and corporate codes of conduct.

Second, the WTO membership will accelerate China's effort to promote transparency, social justice, openness, privatization, and deregulation. The market discipline required by the WTO rules will deepen china's reform on both industries and bureaucracies. Increased FDI and accelerated foreign competition will create pressure for effective organizational change and human resource development in China. Foreign firms and management practices entering China will have to adapt to the Chinese cultural environment in addition to the Chinese economic, political and legal conditions. In this regard, foreign organizations, investors, and policy makers will have much to learn from China and about China. As well, China will have much to learn about the WTO rules and mechanisms for effective management of emerging trade-related conflicts and resolutions. Chinese organizations have much to learn about effective development and efficient uses of China's natural resources, physical and financial resources, and human resources.

Third, China's current status as an economy in transition entails uncertainty to both China and the rest of the world. As shown in this study, China matters as much to the world as the world matters to China. After more than two decades of economic reform, China is no longer a command economy, but neither is China a mature market economy. China's real economic paradox is being somewhere in between. This paradox largely influences trade policies by China's trade partners, China's own economic policies and strategy, further trade liberalization and economic cooperation across borders, and effective conflict resolution under the WTO regime. More rigorous research assessing the complex China effect, conflicting issues and policy alternatives, and the changing status of China's economy is indeed critical in order to gain a better understanding of differences and mutual interests among nations.

Finally, oftentimes trade liberalization and the WTO are faced with heated debates and criticism, particularly because they do not appear equally beneficial to all parties concerned. Classical international trade theories (e.g., Smith, 1776; Ricardo, 1819; Vernon 1966; etc.) suggest that international trade and investment will generate positive synergies for all participating countries and consumers will be the ultimate winner with more alternatives, lower costs, and higher standards of living. More contemporary theories recognize how trade can be altered when markets are not perfectly competitive, or when production of specific products possesses economies of scale (Krugman, 2000). Michael Porter (1990) posits that national prosperity does not grow out of a country's natural environment, its labor pool, its interest rates, or its currency values…, differences in national values, culture, economic structures, institutions, and histories all contribute to competitive success" (pp. 73-74). There are striking differences in the patterns of competitiveness in every country; no nation will be competitive in every industry or even most industries (Porter, 1990). As today's world is increasingly intertwined through the process of economic globalization, positive synergies and competitive advantages will stem from a good understanding of differences and mutual interests among countries. At the same time more global engagement will deepen cross-cultural communication and economic cooperation. Such a new paradigm call for hypothesis testing and effective policy development, which should help promote fair trade, social justice, equity, and environmental protection while minimizing potential costs or unintended negative consequences of globalization.

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AN EXPLORATION OF THE COMPETITIVE ADVANTAGE OF EMPLOYER OF CHOICE PROGRAMS ON INTERNATIONAL HUMAN RESOURCE MANAGEMENT

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ABSTRACT

The competition for knowledge workers has intensified as traditional recruitment markets expand beyond national borders. The infusion of technology in the recruitment process has broadened the reach of employers to locate talent. Multinational corporations find that competition for labor crosses industries and oceans. An MNC needs to market their employer brand in order to remain competitive in the war for talent. The organization that can attract and retain top talent will achieve and sustain competitive advantage. Many human resource professionals believe that the organizations that achieve Employer of Choice status will win the war for top talent. The costs associated with such a strategy are significant yet the outcome of such a position has not been studied. This article suggests, based on existing theory, empirically testable propositions to analyze the effectiveness of Employer of Choice strategy in the global market.

INTRODUCTION

Employer of Choice (EOC) programs are designed to aid an organization in outperforming its' competition in the recruitment and retention of top talent in order to secure an exceptional workforce. It is important to note that "top" in this definition does not refer to the place in the organization chart or structure, rather it is indicative of the best employee, the top performer for each position in the organization.

An Employer-of-Choice is basically a self-proclaimed achievement. Although in order to have credibility in the proclamation, it helps to be named to one of the popular press list of best companies to work for. According to Fortune Magazine's annual list of the best companies to work, companies on the list yield higher returns for shareholders (Shellenbarger, 1998). Sullivan (1998) states that the advantages of EOC status include: "ease in attracting quality talent; good public relations for the organization; improved workforce retention rates; favorable customer image; and ease in maintaining corporate culture and employee motivation because of the shared pride." Konrad and Deckop suggest that "HR can create value by developing systems to make the firm an employer of choice" (2001). In fact, Becker and Huselid posit that the combination of an Employer of choice strategy with high performing work systems, will, in most cases, result in increased financial performance (1999).

According to a report distributed by Watson Wyatt called measuring the competitive fitness of Global firms, world class global companies are lacking in human resource management competency. This study published annually since 1998 analyzed data from 326 leading global companies. It measures twelve management capabilities one of which was human resources. Human Resource Scores have consistently shown that HR functions were one of the weaker capabilities of global firms (Watson, 2002). Yet, clearly, the literature depicts the importance human resource management plays in maintaining an exceptional workforce. Porter (1985) asserts that effective human resource management policies and practices can supply a significant contribution to the firm's competitive advantage because they provide the mechanisms to recruit and retain top talent. The latter is significant as it is the reduction of turnover that has been posited as an important benefit enjoyed by EOCs.

BACKGROUND

The demand for "top" labor is outpacing the available supply, thus creating what Clarke refers to as a "critical labor and skill shortages in virtually all industries requiring specialized core competencies within the workforce" (Clarke, 2001). In fact, organizations have begun to recognize the importance of expanding recruitment areas to extend beyond domestic borders to meet its labor demand. This deficit seems to be contrary to the reported higher levels of unemployment being experienced in many countries, yet it is not the numbers of workers that is in deficit, rather, it is a lack of skills. As Mike Johnson characterizes, "…<w>e are experiencing a skill meltdown…"(2002).

For the next decade at least, employers will continue to face a shortage of knowledge workers. It is not uncommon for many organizations to simultaneously reduce staff while hiring new highly skilled talent. The Bureau of Labor Statistics in the United States projects that during the 2000-2010 period, total employment is projected to increase by 15 percent (BLS, 2001a). In fact, many EOCs have incorporated recruitment and retention goals into their written strategic plan (Ahlrichs, 2000) in recognition of the significance of these key staffing activities. The skill shortage is so critical that it will be those organizations that can successfully position themselves as a 'magnet" for talent that will gain advantage (Johnson, 2002).

LABOR GLOBALIZATION

According to a study conducted by the Society of Human Resource Management, "Ford and IBM employ 54 percent and 51 percent of their workers outside the United States respectively while one-fifth to one-third of employees at AT&T, General Electric, PepsiCo and General Motors work outside US borders" (SHRM, 1999). Nestle has 97% of its workforce located outside of Switzerland and Philips has over 80% of its workforce outside of the Netherlands. Yet another illustration is Fonterra, one of New Zealand's largest companies, which has more of its people working and living outside New Zealand than in it. As a result, the competition for top talent is even fiercer as it is no longer restricted to geographically local competitors but now encompasses a global marketplace. To illuminate this notion of a global labor pool, one needs to consider it vis-à-vis trade theory. For instance, Keenichi Ohmae maintains that in order to be successful, good managers need to learn to lead in a borderless world. A leader can no longer afford to be nearsighted. Instead, in order to be successful they must possess the ability to see the world as borderless. Yet, Ohmae maintains that "the allure of global products is illusive" referring to the fact that while certain products may lend themselves to Levitt's notion of truly global standardize features, many require local responsiveness (Ohmae, 1989). This thinking seems to ring true with Labor, as well. Certainly technology has facilitated multinational "brain circulation" (Patel, 2002). Chinese engineers moonlighting on weekends in Korea and Indian software engineers accounting for up to 30 percent of the information technology workforce in the United States are just two examples of how "brain circulation" is evident in this global labor pool. Moreover, through "electronic immigration" organizations can employ people from virtually any country thus creating a truly global market of the best and the brightest workers.

The aging of the world population presents human resource managers with a significant barrier to meeting talent projections. For instance, Japan will need to import increasingly more talent as its population shrinks. Ireland, similar to China, will import talent in fields where they do not possess a comparative advantage. China has an abundance of cheap labor but needs MBAs to complete its industrialization process (Johnson, 2002). Similarly, the United States continues to import software engineers from India and China in substantial numbers to meet its labor demand. A highly competitive organization needs top talent to maintain the level of success (Kaye and Jordan-Evans, 2002). As markets open and borders blur, will talent management become easier because labor will begin to converge or will local culture continue to dominate the way workers think and work? Research has suggested that global organizations are starting to converge on recruitment practices but remain distinct in selection methodologies which are embedded in national culture (Huo, Huang, et al., 2002). As Hofstede posited, national culture can be differentiated based on its citizens' values and norms as captured in his five (originally he posited four) dimensions of culture. These dimensions differentiate the culture of countries which fall at different points along a continuum in each (Hofstede, 1993).

Organizations have had to respond to an increased demand by employees for "need satisfaction". Employers began offering new and more tailored benefits packages. On-site child-care centers, exercise rooms, and cafeteria style benefits packages surfaced as a benchmark for top benefit plans. Even concierge service and on-site dry cleaners have become a standard in many large organizations. In a recent poll reported in Risk Management, over one quarter of the respondents cited work-life balance as their "number one career dilemma in the new millennium" (Sullivan, 1999). Recent evidence further suggests that even employees with no direct benefit may place a positive value on work-life programs…" (Drago et al 2001). Anderson and Pulich posit that employees want some recognition from management that family and personal time is important (2000).

WHERE IS THE ADVANTAGE?

Is the strategy to become an employer-of-choice truly yielding a competitive advantage for the global firm? Does EOC status energize that magnet to which Johnson referred (2002)? Is EOC status the key to successful talent management for MNCs? Is EOC status advantageous in all cultures?

The answers lie in the synthesis of several literatures: resource-based view of the firm, institutional theory, and human resource theory. To understand the extent of value placed on EOC status for a MNC, one clearly needs to recognize the impact of Hofstede's cultural dimensions. His model discusses how culture impacts work behavior and ultimately various business practices. Since the strategy for becoming an EOC is to create a competitive advantage through the recruitment and retention of top talent, the MNC must understand the extent that cultural differences influence employee perceptions and needs.

RESOURCE-BASED VIEW OF THE FIRM

Since human resources represent the knowledge, skills, abilities and competencies of the employees this mosaic of talent that becomes what Barney (1991) describes as a resource that is relatively rare and difficult to imitate, or as Petaraf (1993) classifies as a "superior productive factor that is in limited supply." Wright and McMahan (1992) support the resource perspective but stipulate the existence of four requirements: individual performance must matter; the employee skills must be rare; the combined human capital can not be readily duplicated and finally, human resources cannot be vulnerable to substitutions – technological or otherwise. As Hitt and Ireland (1986) and Barney (1991) suggest a firm's human resources can be used as predictors of firm performance. Organizations that possess a resource that others are not able to easily duplicate are known as benefiting from a sustained competitive advantage. Thus we argue that one of the underpinnings of Employer-of-Choice strategy lies in resource-based strategy. One can look at Southwest Airlines, repeatedly listed on Fortune magazine's list of the best companies to work for and realize that their business model is simple - -Tom Peters characterized it "as one that any 3 year old can understand"(Myerson, 1997) - -and yet others have failed to imitate it. O'Reilly and Pfeffer (2000) attribute that to the competitive advantage that Southwest has in its human resources.

"Extensive employer-of-choice initiatives can involve the art and reach of a $50 million advertising campaign" (Walsh, 2001). Even more staggering is the time associated with the achievement and then maintenance of such a status. In a recent interview, Cindy Boyle, Vice President for Human Resources at JP Morgan Chase indicated that it requires compiling at least 100 pages worth of information to apply for inclusion on one of the lists. Thus, considerable investment of time and resources are necessary to compete.

Positive reputations can be a source of competitive advantage. The EOC status is an attempt to enhance a member firm's reputation as one that values its employees. A very recent series of commercials promoting Continental Airlines demonstrates that one of their main marketing goals is to enhance the Airlines employment brand by communicating its achievement in being named to Fortune's list of Top Companies to work for. The advertising campaign furthers connects the fact that since their employees are happy, the customers are happy too. It seems Continental's strategic architecture highlights that EOC status is a core competence and as such will provide a sustained competitive advantage. If you view the organization as a "portfolio of skills" the rationale for Continental's strategy becomes intuitive (Prahalad & Hamel, 1990). Lawson and Hepp (2001) studied a "bundle" of integrated human resource management practices at Wells Fargo, called PACA – People As Competitive Advantage – and concluded that indeed human capital is a significant competitive resource and that these bundles make an independent direct impact on both employee and business performance.

HUMAN RESOURCES

Based on the above, it would seem that those organizations with EOC status should have a competitive advantage. Rayman and Bookman (1999) assert that 'while there has been movement in both research and public policy to connect work and team perspectives, the models are limited.' In fact, the human resource literature is mixed on the impact of human resource management and the organization's success. However, recent evidence suggests that investments in human resources are a potential source of competitive advantage (Huselid et al., 1997). Notwithstanding that assertion, Koch and McGrath posit that despite the many "normative connections made between human resource management practices and firm level performance, empirical studies are sparse" (1996). They studied 319 business units and determined that labor productivity is positively related to organizations that invest in thorough human resource planning via effective forecasting of labor supply and demand as well as highly valid selection methodologies (Koch and McGrath 1996). In other words, those organizations that are proactive and recognize the importance of securing labor will experience higher productivity. Huselid, Jackson and Schuler (1997) expressed that the "potential gains" for organizations lie in the effective utilization of strategic human resource management. It is widely believed that employees are motivated to contribute to the organization if they receive rewards that they believe exceed their inputs (March and Simon, 1958). The assumption is that Employers of Choice offer exceptional benefits and therefore since it has been shown that perceptions of organizational culture influence turnover (Sheridan, 1992) as well as employees' financial and psychological interests (Shaw et al, 1998), this is an effective human resource strategy to pursue.

INSTITUTIONAL THEORY

The issue is whether the stated advantages of becoming an employer-of-choice are reality-based or myths. Is the concept of EOC more a norm of rationality? Institutional theory is based on the notion that formal structure is ingrained in social reality. The social reality determines elements of the formal structure such that these elements are merely manifestations of powerful institutional rules which function as rationalized myths that are binding on organizations (Meyer and Rowan, 1977). Organizations structurally reflect or imitate socially constructed values. Perhaps this can explain the motivation of employers to enrich benefit offerings that are required for EOC lists. In other words, conceivably the "competitive advantage" that proponents of these benefit offerings espouse is merely isomorphism (Meyer and Rowan, 1977). In a study of government agencies, the results depicted a disregard for outcome assessments of these Work Life Programs. Once they were offered little was made to ascertain its impact on its effectiveness (Durst, 1999).

It certainly can be argued that if an employer does not offer certain benefits, that employer would forfeit recruitment effectiveness. The "top talent" would seek employment elsewhere. However, not all benefits can have the same added value to the employment relationship. In other words, the enhancement of benefits could be a result of mimetic isomorphism (DiMaggio and Powell, 1983). Employers may be simply responding in an effort to maintain legitimacy by offering benefits. If the organization just offers the benefits to increase its reputation as EOC, then the value to employees is questionable. For example, men and non-professionals cannot take advantage of work-life programs for fear of job ramifications (Konrad and Mangel, 2001). In a global company, "any form of compensation must be aligned with the cultural and economic norms of each operating location" (Krupp, 2002). Therefore, an organization that is deemed an EOC needs to meet that status in all locations it operates since the requirements may be very different.

PROPOSITIONS

Some extend Hofstede's dimensions to motivational issues for human resource managers, and found that while needs of employees are similar they differ in valence as a result of national culture (George and Jones, 1996). Management practices that are "congruent with the national culture have been found to enhance firm performance" (Newman & Nollen, 1996). Schuler and Rogovsky attribute the success of local responsive human resource policies because "congruent HR practices are consistent with existing behavioral expectations and routines that transcend the workplace" (1998, p.161) Some benefits which are generally expected in EOCs, may, in fact, not satisfy any needs in certain countries. Neil Krupp maintains that global organizations must align their rewards, benefits and all compensation to cultural and economic norms of each operating location. (Krupp, 2002) Thus, the question regarding EOC strategy yielding a competitive advantage is tied to the nation's dimensions of culture.

The Individualism dimension attempts to measure the extent to which the culture values individual or group needs. The EOC designation would have greater valence to the employee who is primarily concerned with satisfying his/her own individual needs.

Proposition 1: EOC status will be highly valued in individualistic cultures.

The Masculinity dimension attempts to measure the extent to which the culture values ambition and assertiveness over nurturing and caring. The EOC designation would have greater valence for the employee who believes that the organization has a responsibility for their wellbeing.

Proposition 2: The value of EOC status will be inversely related to highly masculine cultures.

The uncertainty avoidance dimension attempts to measure the extent to which the culture embraces change and ambiguous situations. The EOC designation would have greater valence for the employee that desire structure and commitments from the employer regarding their wellbeing.

Proposition 3: EOC status will be highly valued in high uncertainty avoidance cultures.

The power distance dimension attempts to measure the extent to which the culture embraces unequal distribution of power. Again, if one believes that there should be distinct power levels, than those MNCs would not even attempt to achieve EOC status since meeting employees needs is not a priority. As a result, employees in those nation's that have a higher acceptance of power distance would not place a great value on EOC status. As Hofstede posited, "all societies are unequal, but some are more unequal than others" (1997).

Proposition 4: **EOC status will be highly valued in low-power distance cultures.**

The long term orientation dimension attempts to measure the extent to which the culture values are oriented towards the future, like thrift (saving) and persistence. Again, the EOC status would have greater valence for the employee who believes that the organization will partner with them in protecting their future.

Proposition 5: **EOC status will be highly valued in cultures that subscribe to a long-term orientation.**

DISCUSSION

This area of research is ripe with opportunities to decipher the concept of employer-of-choice as a strategy for increasing competitive advantage in a global market. Global organizations are facing a deficit in the supply of top talent and most assuredly will need to develop strategies to overcome the challenge. Clearly, the notion of an EOC is one such strategy designed to address this organizational concern and many organizations have embraced it. However, it requires considerable resources, both in terms of financial investments and labor hours. In fact, "extensive employer-of-choice initiatives can involve the art and reach of a $50 million advertising campaign" (Walsh, 2001). But, its suggested benefits have not been empirically tested. It is imperative that these supposed competitive advantages be subjected to the rigor of academic research. Implications for MNCs are considerable as any mechanism to alter an organization's competitive advantage relies on significant allocation of resources. If done in ignorance or with untested assumptions, MNCs may find themselves to have embarked on a strategy that may ultimately lead them to negative results in terms of position and performance.

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FINANCIAL STATEMENT RECONCILIATIONS: EXPLORATORY STUDY TYPES AND NUMBERS FOR HONG KONG H-SHARES

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ABSTRACT

The purpose of this research was to gather information about the financial reporting practices for the profit and loss reconciliations in 1997 for Hong Kong H-shares. The H-share financial statements must include a reconciliation between the statements prepared according to PRC accounting standards and either the Hong Kong or International accounting standards (IAS). Annual reports for years ending in 1997 were examined to gather information about the accounting practices for reconciliation items for financial reporting for Hong Kong H-share companies. Thirty-nine companies were selected for study.

Additional accounting guidance for reconciliation items for the profit and loss statements may need to be provided by the Hong Kong Society of Accountants (HKSA) for H-shares in Hong Kong. Some H- share companies may be applying a somewhat different standard. At this time, comparisons among Hong Kong companies may be difficult. Some companies are, apparently, using different formats. Comparisons between the results of this study and an earlier Miller project are presented in the results section.

INTRODUCTION

International financial markets are rapidly becoming a single global market. Investors will continue to be interested in Asian financial markets including Hong Kong (HK). Hong Kong stock market capitalisation is among the largest in the world. Specifically foreign investors have been attracted to H-shares (McElligot, 1996). Very little is known about the financial reporting practices for these H-shares. The Hong Kong Securities and Futures Commission (SFC) executive director has stated it is important to adopt international standards as part of the SFC and stock exchange's commitment to maintaining Hong Kong's competitiveness (Ibison, 1995). China was ranked as the world's third largest economy based on purchasing power parity models in 1993 (Whittall, 1994). Other researchers (Lin, Cai & Li, 1996) also concluded that China has the potential to be one of the world's largest economies. The H-share companies since both the number of firms traded and market capitalisation has been increasing have become more important for the Hong Kong Stock

Exchange. In 1993, three of the five top fundraisers were H-shares and those three companies accounted for 43% of the total funds raised by the top ten listings on the Hong Kong Stock Exchange (Whittall, 1994). The funds raised for the three firms in 1993 were as follows; Maansan Iron & Steel- $511 million (HK$), Shanghai Petrochemical- $377 million (HK$) and Tsingtao Brewery- $115 million (HK$). More recently, funds raised by China-related companies represented 83% of the total funds raised in 1997 (Ward, 1997).

The shares for the first H-share company, Tsingtao Brewery, were sold in 1993. Some Chinese companies are allowed to sell their shares to foreign investors on the Hong Kong Stock Exchange (HKSE) and these shares are called H-shares. Some accounting practices differ in the way profits are determined under International, Hong Kong and People's Republic of China (PRC) accounting standards. For example, international accounting standard (IAS) No. 33 defines earnings as the result after deduction for 1) all expenses including tax, extraordinary items and minority interests and 2) preference dividends (including cumulative dividends that have not been declared. For the PRC, earnings has not been specifically defined. For Hong Kong, earnings per SSAP No. 5, is the same as IAS 33 except that earnings is based on a figure before extraordinary items (Deloitte, 1997). The Hong Kong Society of Accountants is reviewing this definition at the present time. However, there are other differences that result in reconciling items for H-share financial statements. For example, depreciation accounting, the rates to be used to calculate the appropriate bad debt expense and the exchange rates to be used to convert foreign currency transactions are mandated by PRC state regulations. In many cases, these rates are not realistic and therefore adjustments are needed as part of the required reconciliation. Also, inventory and short-term investments are required to be carried at cost by the PRC and further adjustments may be needed to follow either the HK or IASC accounting methods for these areas (Adhikari & Wang, 1995).

Today, forty Chinese companies do sell their shares in Hong Kong (HK). Only Chinese citizens or foreign investors may own two other types (A and B shares) respectively. These shares are traded on either the Shanghai Securities Exchange or Shenzhen Stock Exchange in China that were opened only in 1990 and 1991 respectively.

As discussed, very little detailed information is known about the accounting practices for H-shares. The Hong Kong Stock Exchange (HKSE) is demanding greater transparency for H-share companies partly because the furor that was caused when Dongfang Electrical Machinery and Maashan Iron & Steel disclosed that their deposits placed with mainland-based banks can not be withdrawn (Chan, 1998). Other H-share companies may have similar problems. In addition, the HKSE has recently suggested that H-share firms need to disclose the impact of possible mainland tax changes amid confusion created by a circular issued by the mainland tax and finance authorities. If all H-share companies had to pay the standard thirty-three per cent mainland tax instead of the allowed fifteen per cent at this time, the aggregate H-share profits would be revised even further downward (Wong, 1998). In addition, the lack of transparency for the H-shares has been cited as a factor behind the poor financial performance (Leung, 1996). As of September 1998, only one of the forty H-share firms was still trading at above its' original issue price. In general, the H sector is selling at only about forty to fifty percent of its' book values (Lai, 1998). China has been criticised for having the worst disclosure regulation. The number of China related companies including both H-shares and so called red chip companies (Chinese mainland companies doing most of their business in the mainland, but headquartered in Hong Kong) listed in Hong Kong has grown from five in 1990 to 97 in 1997. In 1996, the head of Coopers & Lybrand's China Audit Technical Group, indicated that the problem is one of practice not standards (SCMP, 1996). However, Hong Kong has been rated as having the best shareholder communications regime in Asia (Fung, 1997). The differences between the, at least, perceived reporting practices for the PRC and HK have been a concern for the Hong Kong Society of Accountants.

LITERATURE REVIEW

No research studies were identified that examined any required financial statement reconciliations for Asian countries. Some work has been done investigating market's valuation of nonreported accounting measures for non-U.S. and U.S. generally accepted accounting principles reconciliations. In one study, the authors conclude that market-to-book ratios in periods predating the initial U.S. Securities and Exchange Commission filings by at least three months are significantly associated with the shareholders' equity reconciliations disclosed in the registrations statement (Rees & Elgers, 1997). Several projects have investigated the relationships between disclosure levels and foreign stock exchange variables. For example, Saudagaran and Biddle (1992) examined if financial disclosure levels influence firms' choices regarding foreign stock exchange listings. They concluded the financial disclosure level influences the choices. Almost all countries require the disclosure of accounting policies. In a survey of thirty-four countries, only China and Norway did not require the disclosure of accounting policies (Coopers, 1993). For those two countries, the disclosures are optional. The IASC, along with Hong Kong, do require accounting policy disclosures. The disclosure of the significant accounting policies used should be an integral part of the financial statements according to the IASC (IASC, 1993). For many specific disclosure topics, the requirements are also similar for the IASC and Hong Kong. In the next section, more details will be provided.

During the 1970s and 1980s, the IASC, US, UK, Canada and Australia achieved accounting standard compatibility in very few areas. During the 1990s, considerable progress has been made. Agreement had been reached in areas including EPS, segment reporting, deferred taxes and leases. However, no consensus has been reached in other topics such as correction of errors, research and development and interest capitalisation (Street & Shaughnessy, 1998). No general framework for a worldwide comparison of disclosures in different countries exists. Several surveys including the Coopers and Lybrand's project (1993) have been conducted in the past.

Some researchers have investigated the differences in accounting requirements for different countries in the world. In one study, the disclosure frequency was greater in the US than in the UK for the sample firms (Frost & Pownall, 1994). The researchers arbitrarily selected 13 domiciles including the US and the UK for broad geographical representation. Equal numbers of firms from each domicile were selected for this study. Only firms that were continuously listed from 1 January through 31 December 1989 were included in the sample. A firm is likely to release similar financial statements in the US and UK, but its' other disclosures may be different because of different local conditions. UK and HK disclosure requirements should be similar because the HK disclosures had been based on UK requirements before 1993.

Researchers have studied various aspects for the income statement presentation issues. In a United States study, the researcher discovered that the stock market apparently recognizes that a company that repeatedly produces unusual expense items may have substantive issues to face either in their businesses and markets or in the decision-making ability of their leadership. Evidence indicates companies reporting extraordinary items three or more years in a five-year period may be penalized by the stock market by an adjustment in stock price (Clayman, 1995). However, the market seems to forgive and forget once the period of reporting extraordinary items is over since some of the stock prices for these firms are able to increase faster than a broad index. Perhaps because extraordinary items are becoming rare for financial reporting, firms may use exceptional items to smooth income in the future.

Other researchers have examined the issues of possible income smoothing with the use of extraordinary items. In a study based on Australian companies, Hoffman and Zimmer (1994) conclude that the tendency to classify recurring gains rather than losses as operating rather than extraordinary items is greater where the chief executive receives higher remuneration relative to firm earnings. There is evidence firms may use extraordinary item adjustments to manipulate and "smooth" income (Craig & Walsh, 1989). Lynn and McGuinness (1994) did not find evidence of profit smoothing using extraordinary items for Hong Kong. Another study (Aharony, Lee & Wong, 1997) used a sample of 83 Chinese firms issuing B-Shares and H-shares and found that new issuers' accounting earnings peaked in the year of the new issue and declined in the subsequent three years after the issue. They found evidence suggesting that Chinese companies issuing shares for the first time manipulate their accounting earnings during the year of the initial public offering by accelerating credit sales to their customers. Several researchers have discussed the approach, "big bath accounting" (Elliot & Shaw, 1988). This concept implies companies may be inclined to use extraordinary items to decrease profits significantly in one year so that in subsequent years the rates of return based on assets or equity would be higher.

The purpose of this research was to gather information about the financial reporting practices for the profit and loss reconciliations in 1997 for Hong Kong H-shares. This study will provide some preliminary information about the stock market listing of PRC companies on the Hong Kong Stock Exchange. No similar studies were identified during the literature search. The financial statements must include a reconciliation between the statements prepared according to PRC accounting standards and either the Hong Kong or International accounting standards (IAS). All companies traded on the HKSE must prepare their respective financial statements using either the HK or international standards. Part of the objective was descriptive. The numbers and types of reconciliation items will be described in this project. Thus, little is known about the accounting practices for the H-shares. Descriptive statistics will be included in the study. Statistical tests will be used to study if there are significant differences between PRC profit and profit based on either the HK or IAS standards. Comparisons including statistical measures between the results for this and another study will be presented here.

Several research issues were examined during this study. As discussed, the H-share companies must reconcile their statements prepared using the PRC standards with either the Hong Kong or International standards. All firms traded on the HKSE must follow one of the two standards. Do the reconciliation items provide information to the potential investor? Is the investor able to differentiate between the PRC profit and the adjusted profit based on HK or International standards? As a first step, this study determines if there are significant differences in the means for the two measures.

METHODOLOGY

Annual reports for years ending in 1997 were examined to gather information about the accounting practices for reconciliation items for financial reporting for Hong Kong H-share companies. Thirty-nine companies were selected for the study. See Table 1 at the end of the article for the complete company list.

The thirty-nine companies represent almost all of the H-share companies traded on the Hong Kong Stock Exchange in 1997. Financial data was not available for one firm. All companies had 31 December 1997 year-ends.

Several approaches are used in the analysis. The hypothesis to be tested follows:

H1: There is no difference between the profit based on PRC standards and the profit based on either the HK or International standards.

This approach has been used in a similar study (Lynn & McGuiness, 1995). Tests will be conducted to determine if H1 can be rejected statistically. T-tests and a Wilcoxon non-parametric test will be used for analysis purposes. Comparisons of the coefficients of variation (CV) of PRC profit and adjusted profit will be made for the sample in this study. This technique has been used in several other studies (Craig & Walsh, 1989; Lynn & McGuinness, 1995).

The CV attempts to capture the volatility of profits for a given mean dollar amount of profits. If reconciliation items are useful, it is expected that a higher CV in PRC profits would be observed as compared to the CV for adjusted profits. The CV measure provides useful insight into profit volatility where a relatively short time-series of earnings is available (Craig & Walsh, 1989). If data is available for a longer time frame, the hypothesis can be examined using a different time-series model of profits. However, in Hong Kong only annual profits are generally available (interim reports are not audited) and H-shares have only been traded for a short period of time. Based on these facts, the CV approach is appropriate in this case.

Because of the small sample size, a t-test may not be appropriate. A non-parametric test (Wilcoxon paired sample) is better than the t-test when you have a small sample size and the population distribution is unknown.

RESULTS

Several variables were examined for each of the annual reports. The discussion is grouped according to these variables. Descriptive statistics are presented in the first section. The mean profit for companies based on the PRC standards for 1997 was $201,243 (RMB'000). The adjusted mean profit based on either the HK or IAS standards for 1997 was $208,139 (RMB'000). The average for all H-share companies including those with no reconciling items was $260,975 (RMB'000). See Table 1 for details.

Descriptive Statistics

Number of Companies with Reconciliation Items

For 1997, twenty-two companies of the thirty-nine or 56.4% had one or more reconciliation items listed in their respective profit and loss statements (see Table 1).

The other companies had no material differences between the PRC based and HK or IAS financial statements. Only two companies had a loss for the year. The eighty-three reconciliation items were classified into forty-seven categories. These categories were further grouped into seven general groups as follows, 1) doubtful accounts, 2) valuations- Fixed Assets, 3) amortisations, 4), deferred tax, 5) slow moving inventory, 6) other write-offs and 7) others. See Table 5 for details.

Number of Reconciliation Items

As discussed, there was a total of eighty-three reconciliation items for the twenty-two companies for 1997. The H-share companies provided the PRC profits and adjusted profits (either HK or International) reconciliations in their respective 1997 annual reports. Please see Table 5 for details. Because of space limitations, only data for six firms are displayed. All types of adjustments for entire sample are presented.

Table 4 - Types of Items By Category	
TYPES OF RECONCILING ITEMS	
Categories	Number
Doubtful Accounts	9
Valuations- Fixed Assets	7
Amortisations	7
Deferred Tax	3
Slow Moving Inventory	5
Other Write-offs	2
Other	50
	83

Table 5- Examples of Reconciliation Items For Six Companies

RECONCILIATION ITEMS	1	3	4	6	7	8
Total companies: 22						
Original Format	PRC	PRC	PRC	PRC	PRC	PRC
Income before adjustment	$108,541	$65,374	($32,658)	$56,152	$579,263	$829,681
Valuation and depreciation of expressway and structures	$32,485					
Valuation and amortization of land use rights	$5,060					
Deferred taxation	($6,456)					
Consequential adjustment on net assets		$1,212				
Provision for slow moving inventories		($6,826)				
Provision for bad and doubtful debt		($3,131)		($7,000)	($3,016)	
Receipt of option payments recognized as income		($3,483)				
Others		($4,436)				$601
Amortization and depreciation of other assets			($2,193)			
Valuation and depreciation of fixed Assets					($15,449)	
Write back on deferred VAT receivable						
Fixed assets written off						
Exchange gains in respect of funds borrowed for fixed assets						
Interest income from share proceeds						
Tax adjustments						
Amortization of exchange gain result from unified exchange rate						
Difference between provision for bad debts and write-off of trade receivable						
Additional charge for staff welfare fund						
Government subsidy						

Table 5- Examples of Reconciliation Items For Six Companies

RECONCILIATION ITEMS	1	3	4	6	7	8
Reversal of amortization / recognition of intangible asset						
Additional depreciation charge						
Amortization of intangible asset						
Diff. in valuation of capital (sub)		$31				
Gain on disposal of fixed asset			$1,524			
Add. depr. on fixed asset - diff. in each yr. gain capitalization						
Amortization of negative goodwill -not allowed in HK GAAP						
Amortization of deferred exchange diff. of associate company over 5 yrs under						
PRC GAAP						
Amortization of pre-operating expenses of associate company over 5 yrs under						
PRC GAAP						
Minority Interest						
Amortization of trademark						
Share of profit- associated companies						
Foreign Currency Change						
Amortization of loss of disposal of staff dormitories at preferential price						
Provision for major overhaul						
Reversal of depreciation - revaluation						
Difference in depreciation policy						
Write back of provision of loss of fixed asset - discontinued production						
Amortization of Goodwill						
Recognition of interest - over-subscription of H-shares offering						
Over provision of education fund						
Overprovision of welfare expenses						
Difference in write-off of inventory						
Add. provision for loss in value of investment						
Add. staff housing fund						
Unutilized accrued R&D expenses						
Income tax reduction adjustment						
Net gain on disposal of vessels						
Timing difference in recognition of income, expenses net prior year reversal						
Adjusted income	$139,630	$48,741	($33,327)	$49,152	$560,798	$830,282
Adjusted Format	IAS	HK	HK	HK	IAS	IAS

The numbers on the top of the table refer to the number for each company listed in Table 1. The largest reduction ($37,579 (RMB'000)) was for the reconciling item related to the difference between provisions for bad debts and write-off of a trade receivable for Tsingtao Brewery. The largest addition ($188,645 (RMB'000)) was the adjustment needed for the difference in depreciation policy for Beijing Yanhua Petrochemical. Five companies, also, provided an additional reconciliation between the profit based on IAS and profit based on the United States (US) standards. There was a total of seventeen reconciling items classified into thirteen categories for these five companies. The average profit for the five companies based on IAS standards was $687,075 (RMB'000). The average adjusted US profit was $101,174 more for an average $788,249 (RMB'000). The biggest adjustment (total $133,491 (RMB'000)) for Shanghai Petrochemical for one of the categories was due to the depreciation reduction for the revaluation of fixed assets because asset revaluation is not allowed under US generally accepted accounting principles. Most of the differences were, in fact, due to different valuation methods.

Table 6- Reconciliations From IAS TO US GAAP

RECONCILIATION ITEMS	8	11	18	31	33	TOTAL	AVG
Total companies: 5							
Original Format	IAS	IAS	IAS	IAS	IAS		
Income before adjustment	$830,282	$99,792	$726,472	$686,238	$1,142,592	$3,485,376	$697,075
Valuation, amortization of land use rights					$34,516	$34,516	$6,903
Deferred taxation	($7,263)				($71,521)	($78,784)	($15,757)
Valuation, depreciation of fixed assets	$48,422				$77,000	$125,422	$25,084
Gain/loss of different exchange rate			$37,054			$37,054	$7,411
Capitalization of fixed asset			$21,703			$21,703	$4,341
Depreciation change for revaluation of fixed asset		$1,452	$133,491			$134,943	$26,989
Tax adjustment for revaluation of fixed assets		($31,508)	($28,837)			($60,345)	($12,069)
Reduction of depreciation on fixed assets due to restructuring		$92,495				$92,495	$18,499
Depreciation change for revaluation of fixed asset of Jilian		$7,630				$7,630	$1,526
Interest capitalization					$82,100	$82,100	$16,420
Reduction in depr. on fixed asset - foreign exchange loss on interest capitalization on fixed asset		$1,531				$1,531	$306
Employee housing expenses				($23,920)		($23,920)	($4,784)
Recognition of interest - over-subscription of H-shares offering				$81,522		$81,522	$16,304
Adjusted income	$871,441	$171,392	$889,883	$743,840	$1,264,687	$3,941,243	$788,249
Adjusted Format	US	US	US	US	US		

Table 2- Reconciliations for Twenty-two Companies									
RECONCILIATION ITEMS									
ITEMS	1	3	4	6	7	8	11	12	16
Total companies: 22									
Original Format	PRC	PRC	PRC	PRC	PRC	PRC	PRC	PRC	PRC
Income before adjustment	$108,541	$65,374	($32,658)	$56,152	$579,263	$829,681	$93,013	$40,899	($319,101)
Adjusted income	$139,630	$48,741	($33,327)	$49,152	$560,798	$830,282	$99,792	$34,949	($335,984)
Adjusted Format	IAS	HK	HK	HK	IAS	IAS	IAS	HK	HK
	17	19	20	21	23	24	26	27	28
Original Format	PRC	PRC	PRC	PRC	PRC	PRC	PRC	PRC	PRC
Income before adjustment	$3,750	$26,882	$102,227	$4,543	$640,281	$523,878	$84,465	$207,144	$50,331
Adjusted income	($74,587)	$27,145	$28,394	$44,302	$667,699	$524,600	$81,136	$211,800	$51 ,219
Adjusted Format	HK	HK	HK	IAS	IAS	HK	HK	HK	IAS
	29	31	32	37					
Original Format	PRC	PRC	PRC	PRC					
Income before adjustment	$510,700	$442,518	$95,691	$313,762					
Adjusted income	$493,483	$687,238	$107,707	$334,853					
Adjusted Format	IAS	IAS	IAS	IAS					
t-Test: Paired Two Sample for Means									
	Variable 1	Variable 2							
Mean	201242.5	208137.4							
Variance	7.51E+10	86900000000							
Observations	22	22							
Pearson Cor relation	0.980322								
Hypothesized Mean Difference	0								
df	21								
t Stat	-0.5387								
P(T<=t) one-tail	0.29788								
t Critical one-tail	1.720744								
P(T<=t) two-tail	0.59576								
t Critical two-tail	2.079614								

RESULTS FOR HYPOTHESIS TESTING

A t-test is performed first but because of the small sample size, a non-parametric is, also, conducted. The coefficients of variation are, also, calculated. The results of the tests are shown in Tables 2 and 3.

T-Test

A test on profit differences yields a t-value of -.5387. The critical value at 5% for a sample size of 22 is 1.72 so the null hypothesis cannot be rejected. These results indicate that there is no significant difference between profit based on the PRC standards and profit determined by the HK or IAS standards.

Coefficients of Variation

The coefficients of variation (CV) for PRC and adjusted profits were computed for 1997 for the H-shares. See Table 3 for details. The 1997 CV for the PRC profit and adjusted profit was 1.36 and 1.42 respectively. Since the CV is slightly lower for PRC profit, there is little evidence that there is a difference in the volatility for the profits based on the two different measures. The difference is not significant so the null hypothesis cannot be rejected.

Non-parametric Test

The sum of the R+s for 1997 is -9 so the null hypothesis cannot be rejected. This is further evidence that the means for PRC and adjusted profits are not significantly different. See Table 3 for details at the end of the article.

Statistical Analysis for Table 3

	Profit before Reconciliation	Profit after reconciliation
Mean	201243	208139
Standard Error	58439	62833
Median	94352	90464
Standard Deviation	274105	294712
Coefficient of Variation before reconciliation	274105/201243=1.36	
Coefficient of Variation after reconciliation	294712/208139=1.42	

COMPARISON WITH 1996 STUDY

Thirteen PRC companies qualified as H-shares in 1997. As presented in Table 7, the number of companies has increased from twenty-seven to thirty-nine (one missing in 1997 because of lack of data availability). Table 7 presents a comparison for this study and another Miller project that examined 1996 results (Miller, 1998). The results are quite similar. For each of the two years, there were no significant differences between the profits based on the PRC rules and the IAS or HK standards. 56.4% of the H-share companies had at least one reconciling item in 1997. A similar 54.5% for firms in 1996 had at least one reconciling item. Each firm in 1997 had an average 3.77 reconciling items. For 1996, the average was 3.42.

Table 7- Comparisons for Two Studies

COMPARISONS OF RESULTS FOR 1997 AND 1996		
	1997	1996***
Number of Companies	39	22
Average Profit	260,975	212609
Number of Companies With Reconciling Items	22	12
Number of Reconciling Items	83	41
Profit Based on PRC Standards	201243	305498
Adjusted Profits (IAS or HK)	208137	296585
T-test For Difference In Profits	-0.539	0.642
Coefficients of Variation Profit	1.36	1.31
Profit After	1.42	1.29
Number of Firms with Further Reconciliations To US Standards	5	4
Profits Based on IAS Standards	697075	747189
Adjusted US Profit	788,249	832373

SUMMARY

Additional accounting guidance for reconciliation items for the profit and loss statements may need to be provided by the HKSA for H-shares in Hong Kong. Many companies provided reconciliation items in 1997. The level of detail does vary greatly for these companies. Some firms included extensive details about the needed adjustments. Others did not include the same level of detail. The formats for the reconciliations, also, varied. For example, most companies used the PRC profit and loss statement as the starting point and then reconciled to the HK or IAS standards.

However, some other firms used the HK or IAS profit and loss as the base and then reconciled to the PRC standards. These differences in format may make comparisons more difficult.

In the future, more Chinese companies will probably qualify to be traded as H-share companies on the HKSE. For example, Sichuan Chemical is a current listing candidate. Investors will want to make comparisons among firms to determine which companies' shares to buy or sell. This study indicates that there are not significant differences between the 1997 PRC profit and loss and the profit and loss based on either the HK or IAS standards. However, the number of H-share companies was still relatively small for 1997. Any conclusions must also be considered carefully because H-shares have been traded for only a short time. Future research is needed to confirm the results.

The Hong Kong Society of Accountants may need to evaluate the accounting practices for the reconciliations. The H-share companies may be applying a somewhat different standard. At this time, comparisons among Hong Kong companies may be difficult. Some companies are apparently, using different formats. If standards are applied consistently, this should increase the comparability among H-shares and other companies traded on the HKSE by standardising the required adjustments. Research in the future should be conducted to confirm that the reconciliation practices become similar for the H-share companies. Consistent practices may be critical in the future. It is hoped that this study has provided some useful information about the status of corporate financial reporting for H-share firms. As discussed, research will need to be conducted to confirm the results of this study and also to determine if changes occur over time.

This study is subject to several limitations. First, H-share companies have been traded on the Hong Kong Stock Exchange only since 1993. Any statistical tests are limited because data is available only for five years. Second, only twenty-seven companies were listed as of 1996. An additional thirteen firms were granted permission to be traded in 1997. Sample size is necessarily small so any conclusions must be evaluated carefully. No attempt was made in this preliminary study to determine if investors can differentiate between the PRC earnings and HK reported earnings. Also, future research will be needed to determine general market reactions to any changes in the reporting requirements. For this study, a major objective was descriptive since very little is known about existing accounting practices for H-share companies traded on the Hong Kong Stock Exchange.

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Table 1: List of Companies with selected financial data											
No	Companies	Year	Net Asset	Total Asset	Profit Before Recon-Ciliation	Profit for Companies with Reconciliation Items	Profit 97	# Recon-cil	Type of Reconcile	Further Recon..	Further Type Reconc..
1	Anhui Expressway	Dec-97	2768071	2894389	108541	139630	139630	3	IAS	0	-
2	Beijing Datang	Dec-97	9645296	13232000	-		358269	0	-	0	-
3	Beiren Printing	Dec-97	922221	1105020	65374	48741	48741	6	HK	0	-
4	Chengdu Telecom	Dec-97	969022	1508404	(32,658)	(33,327)	(33,327)	2	HK	0	-
6	Dongfang Electric	Dec-97	1191761	2223416	56152	49152	49152	1	HK	0	-
7	GuangdongKelonEl	Dec-97	3091130	5017639	579263	560798	560798	2	IAS	0	-
8	Guangshen Railway	Dec-97	9310566	12141984	829681	830282	830282	1	IAS	2	US
9	GuangzhouShipyard	Dec-97	1708756	3073105	-		39678	0	-	0	-
10	Harbin Power	Dec-97	3751640	8621730	-		60024	0	-	0	-
11	Jilin Chemical	Dec-97	6030335	15457706	93013	99792	99792	7	IAS	5	US
12	Jingwei Textile	Dec-97	750158	1155208	40899	34992	34992	5	HK	0	-
13	Kunming Mach	Dec-97	581351	646873	-		957	0	-	0	-
14	LuoyangGlass	Dec-97	1870231	3443565	-		(223,445)	0	-	0	-
15	Maanshan Iron/Steel	Dec-97	12016762	17892607	-		61622	0	-	0	-
16	Nanjing Panda	Dec-97	1041945	3723874	(319,101)	(335,984)	(335,984)	7	-	0	--
17	China Shipping Dev	Dec-97	3865245	9251753	3750	(74,587)	-74587	5	HK	0	-
18	Shanghai Petrochem	Dec-97	12519810	20920400			726472	0	IAS	4	US
19	Tianjin Bohai	Dec-97	2167076	6902167	26882	27145	27145	2	HK	0	-
20	Tsingtao Brewery	Dec-97	2342233	3928765	102227	28394	28394	10	HK	0	-
21	Yizheng Chemical	Dec-97	8214945	12963727	4543	44302	44302	3	IAS	0	-
22	Zhejiang Expwy	Dec-97	8200068	11466377	-		296332	-	-	0	-
23	Zhenhai Refining	Dec-97	6158080	9356401	640281	667699	667699	3	IAS	0	-
24	Qingling Motors	Dec-97	5099943	8711158	523878	524600	524600	1	HK	0	-
25	Northeast Electric	Dec-97	1709578	3649389	-		84022	-	-	0	-
26	Shandong Xinhua	Dec-97	817738	1249279	84465	81136	81136	6	HK	0	-
27	Shenzhen Expwy	Dec-97	3772792	5094804	207144	211800	211800	2	HK	0	-
28	AnhuiConchCement	Dec-97	1804805	2427575	50331	51219	51219	2	IAS	0	-
29	Angang New Steel	Dec-97	4838383	6132413	510700	493483	493483	3	IAS	0	-
30	Beijing North Star	Dec-97	4911336	6877443	-		370383	0	-	0	-
31	BeijingYanhuaPetro	Dec-97	5460795	7600671	442518	687238	687238	6	IAS	2	US
32	CATIC Shenzhen	Dec-97	915500	1795500	95691	107707	107707	5	IAS	0	-
33	China Southern Air	Dec-97	9769038	32489629			1142592	0	-	4	US

Table 1: List of Companies with selected financial data

No	Companies	Year	Net Asset	Total Asset	Profit Before Recon-Ciliation	Profit for Companies with Reconciliation Items	Profit 97	# Recon-cil	Type of Reconcile	Further Recon..	Further Type Reconc..
34	ChongqingIron/Steel	Dec-97	1707644	3701819	-		213709	0	-	0	-
35	First Tractor	Dec-97	2304317	3149786	-		283847	0	-	0	-
36	Jiangxi Copper	Dec-97	3781286	6320821			401040	0	IAS	0	-
37	Jiangsu Expressway	Dec-97	10418723	12313805	313762	334853	334853	1	IAS	0	-
38	Guangzhou Pharm	Dec-97	1476043	3102140	-		42315	0	-	0	-
39	Huangeng Power	Dec-97	15513601	35489360	-		1662008	0	-	0	-
40	Sichuan Expwy	Dec-97	4161884	5385782	-		79127	0	-	0	-
TOTAL			177580108	312418484	4427336	4579065	10178017	83		17	
AVERAGE			4439503	7810462	201242.55	208139.32	260974.79	2.1		0	

Table 3- Coefficient of Variation Tests

No	Companies	Year	Net Asset	Total Asset	Profit Before Reconciliation	Profit for Companies with Reconciliation Items	Difference	Absolute	Rank of Absolute	Sign of Rank
1	Anhui Expressway	Dec-97	2768071	2894389	108541	139630	-31089	31089	17	-17
3	Beiren Printing	Dec-97	922221	1105020	65374	48741	16633	16633	12	12
4	Chengdu Telecomm	Dec-97	969022	1508404	(32,658)	(33,327)	669	669	3	3
6	Dongfang Electric	Dec-97	1,191,761	2223416	56152	49152	7000	7000	10	10
7	Guangdong Kelon El	Dec-97	3091130	5017639	579263	560798	18465	18465	15	15
8	Guangshen Railway	Dec-97	9,310,566	12,141,984	829681	830282	-601	601	2	-2
11	Jilin Chemical	Dec-97	6,030,335	15,457,706	93013	99792	-6779	6779	9	-9
12	Jingwei Textile	Dec-97	750158	1155208	40899	34992	5907	5907	8	8
16	Nanjing Panda	Dec-97	1,041,945	3723874	(319,101)	(335,984)	16883	16883	13	13
17	China Shipping Dev	Dec-97	3865245	9251753	3750	(74,587)	78337	78337	21	21
19	Tianjin Bohai	Dec-97	2,167,076	6902167	26882	27145	-263	263	1	-1
20	Tsingtao Brewery	Dec-97	2,342,233	3928765	102227	28394	73833	73833	20	20
21	Yizheng Chemical	Dec-97	8,214,945	12,963,727	4543	44302	-39759	39759	19	-19
23	Zhenhai Refining	Dec-97	6,158,080	9356401	640281	667699	-27418	27418	18	-18
24	Qingling Motors	Dec-97	5,099,943	8711158	523878	524600	(722)	722	4	-4

Table 3- Coefficient of Variation Tests

No	Companies	Year	Net Asset	Total Asset	Profit Before Reconciliation	Profit for Companies with Reconciliation Items	Difference	Absolute	Rank of Absolute	Sign of Rank
26	Shandong Xinhua	Dec-97	817738	1249279	84465	81136	3329	3329	6	6
27	Shenzhen Expressway	Dec-97	3,772,792	5094804	207144	211800	-4656	4656	7	-7
28	Anhui Conch	Dec-97	1,804,805	2427575	50,331	51,219	-888	888	5	-5
29	Cement Angang New Steel	Dec-97	4,838,383	6132413	510700	493483	17217	17217	14	14
31	BeijingYanhua Petrochem	Dec-97	5460795	7600671	442518	687238	-244720	244720	22	-22
32	CATIC Shenzhen	Dec-97	915500	1795500	95691	107707	-12016	12016	11	-11
37	Jiangsu Expressway	Dec-97	10418723	12313805	313762	334853	-21091	21091	16	-16
		81951467		132955658		4427336	4579065			
SumRs=-9		-9								
Average		3725067		6043439		201243	208139			

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