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## **The Effects of Culture and Politics on Foreign Direct Investment and Sustainable Development in China: Some Research Hypotheses**

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### **Abstract**

Considering that China's GDP reached US\$1.159 trillion in 2001 [making it the sixth largest economy in the world - (UN 2003)], and in addition the Chinese government has reformed its economy, liberated market forces and opened up many industries to foreign investors (Cui and Liu 2000), China should hold many attractions for foreign companies (Qu and Ennew, 2003). However, the resultant surge of inward Foreign Direct Investment (FDI) to China will inevitably have consequences for the natural environment, with a consequent effect upon the sustainability of the Chinese – and, indeed the global – economy. It is therefore important to consider the factors which might affect the degree of consideration given to sustainability in FDI decisions. This paper suggests some hypotheses for investigation, concerning the impact of cultural, political and financial factors on the sustainability of FDI projects in China.

### **Keywords**

China, Sustainable Development, Foreign Direct Investment, Culture, Politics

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## **INTRODUCTION**

An important issue in sustainable development in the early twenty-first century is the rapid development of emerging economies such as China and the challenges that this poses in terms of accommodating this growth within the natural resources available on the planet. According to the World Bank, the Chinese market offers the greatest potential for business growth among large developing countries (World Bank 1997, Yang and Lee 2002) and this raises the question of whether this growth can be achieved on an environmentally sustainable basis. Our Common Future (UNWCED 1987) raised numerous issues, partially followed up at the Earth Summits in Rio in 1992 and Johannesburg in 2002, relating to the effects of human and industrial activity on the environment, the equitable distribution of the earth's natural resources and the sustainability of economic development. These issues are of particular importance in the planning of investment projects in rapidly growing emerging markets where the impact of economic growth on the environment and the demands on the earth's resources could be substantial.

The change from a command economy to a social market (Gordon 1991) presents the possibility for additional pressures on natural resources as well as the opportunity to develop new mechanisms for encouraging sustainability in business enterprises, mechanisms driven by long-term commercial imperatives rather than short-run government fashions. According to Luo (2000) and Zhou et al., (2002) the economic reforms have left most Chinese firms facing a mixture of hierarchical and market institutions, deficits in business law and strong government control over limited resources. Similarly, multinational firms doing business in China are

exposed to unfamiliar ideas and regulatory structures which require them to expand their knowledge and develop the ability to respond to a wide range of institutional and market pressures (Cui and Liu 2000).

The purpose of this paper is to discuss the factors affecting international businesses in China in the light of the changes occurring in the Chinese economic system, the market for goods and services in the country and the state of technological development both in China and in the world at large. The overarching aim is to explore the cultural, technological and political background to the Chinese market and to develop some research hypotheses that can be investigated in future research in order to provide an insight into the critical factors for the sustainability of investment projects in China by overseas businesses.

The rapid growth and substantial population of China has serious implications for the sustainability of business projects in the country (Story 2003, pp.62-63). Although the effects of human activity on the natural environment and the depletion of non-renewable natural resources can be mitigated by efficiency gains (UNCWED 1987, pp.173-174, Cairncross 1991, p.43), it cannot be negated, reversed or entirely prevented. All other things being equal, the greater the amount of human economic activity the greater the amount of environmental degradation (UNWCED 1987, pp.45, 174-175 and 206, Cairncross 1991, pp.107-110, Smith 1995, p.64, Meadows 2000) i.e. the greater the conversion of usable resources into unusable or harmful substances. Furthermore, the rate of conversion of natural resources per head in China is presently far lower than that in developed countries such as the US or UK precisely because the amount of economic activity, measured by GDP, per head is lower. In 2001, Chinese energy consumption per head was 1.069 MWh, compared with 12.896 MWh for the United States and 6.192 MWh for the United Kingdom (International Energy Agency 2004). Therefore, if the Chinese people are to attain to the level of economic development enjoyed by richer nations then this will have very serious implications for global economic sustainability (Morita et al. 2000, van Vuuren et al. 2003). If, on the other hand, the Chinese people are to be denied this level of economic development, this raises serious questions about the equity of the distribution of the benefits of the conversion of natural resources or eco-justice (UNWCED 1987, pp.52, 77 and 141, Bebbington et al. 1999).

## **INSTITUTIONAL CHANGES IN CHINA**

According to Wong (2004, p. 155) Deng Xiao Ping concluded in the late 1980s that the legitimacy of the communist party could only be redeemed by the success of modernisation and a more liberal life for the people. Cui and Liu (2000, p. 55) indicates that the advent of the consumer society in China following the commencement of the open-door policy in 1979 has attracted many international companies including at least 200 of the top 500 global companies. This process was given added impetus by the negotiations leading up to Chinese membership of the World Trade Organization in December 2001.

The Chinese government has adopted a number of measures to attract overseas business, while retaining overall control of economic activity (Panigrahi et al. 2002), including the creation of Special Economic Zones for investment (Zhou et al. 2002), the opening of coastal cities to foreign trade (Zhou et al. 2002), laws permitting the creation of joint ventures (Gelatt, T.A. 1989, Chow 1998, Gilligan and Blaney 1998, Hickman and Miller 1998), laws allowing the

licensing of foreign accounting firms (Lau and Yang 1990, Hao 1999) and measures to permit the use of foreign currency in banking transactions by foreign investors (Yang and Lee 2002).

### **Cultural Factors**

The social and cultural factors and funding arrangements changed dramatically when the state changed the funding formula of state owned enterprises from direct allocations to financing through bank loans (Wong 2004). As Wong indicates, the financial, social and cultural aspects of policy are all intricately linked. They can also all affect priorities and sustainability planning. In relation to FDI, however, the situation is further complicated by the fact that at least two sets of cultural influences are at work – those of the host nation, in this case China and those of the country of origin of the organization making the investment.

### **Political Factors**

The process of political reform in the People's Republic of China and the development of a social market economy under the continued dominance of the Chinese Communist party has been documented in a number of books and articles (*e.g.* Deng and Dart 1994, Chang 2001, Yang and Lee 2002, Zhou et al 2002, Story 2003, Woetzel 2003, Wong 2004).

In order to become a member of the World Trade Organisation (WTO), the Chinese government has reformed its economy, installed market forces, and large number of industries to foreign investors (Cui and Liu 2000). China has also reduced tariffs barriers, the number of products requiring import licenses, revised customs laws, and strengthened intellectual property protection. At the macro-economic level, its GDP reached \$954 billion in 1998, making the sixth largest economy in the world (US-China Business Council, 1999). It is therefore important for business managers to come to terms with government policy and to be prepared to understand the regulatory environment in China if they wish to make a success of FDI projects and joint ventures in the country (Deng and Dart 1994). It may, however, be borne in mind that the open-door policy allows the acceptance of some Western influence in the details of business strategy and therefore the Chinese government has been building a strategy to allow overseas firms to break through the old system and favours the use of Western strategies in the establishment of joint ventures (Yang and Lee 2002).

## **FOREIGN DIRECT INVESTMENT IN CHINA**

Foreign direct investment plays a considerable role in the Chinese economy. Since China opened its door to the international market and foreign direct investment (FDI), it has become one of the most attractive recipient areas for foreign companies. China accounted for 42% of total FDI in Asia by 1999 (World Bank, 2000) and by June 2003 it is estimated there will be over 443,000 foreign investment enterprises approved in China. (Luo, 2000).

Sustainability issues in FDI projects in China will be of enormous significance to the sustainability of the world economy in general in the next century and beyond (Story 2003, p.62, Woetzel 2003, pp.103-104). It is therefore important to consider the factors which will affect not only the short-term success of FDI decisions but also their long-term environmental impact, which will in turn affect long-term social and economic outcomes (UNWCED 1987, Zhao 2003). Naturally, the impact of individual projects may be small. However, by taking account of sustainability issues in individual projects, the overall prospects for sustainable development in

the country and in the world as a whole can be improved.

It is therefore important to understand the factors which can help to promote the consideration of long-term sustainability assessments and planning in FDI decisions. The remainder of this paper is intended to provide some general directions for future research in this area by providing some hypotheses, expressed in very general terms which can be used in future research into the best ways of encouraging organizations to assess the long-term environmental (and consequently social and economic) impact of their FDI plans. The testing of these hypotheses will require the development of more specific definitions of the variables involved. However, we consider that it is important to develop general theories and hypotheses first, in order to provide a clear indication of the general forces involved in the shaping of FDI plans, leaving the choice between different options for the operationalization and measurement of these variables for future stages of research.

## **HYPOTHESIS DEVELOPMENT**

This section develops attempts to develop some hypotheses for further research on the relationships between culture, politics and technology and two aspects of Foreign Direct Investment – short-run business success and long-term sustainability.

In this paper we are concerned with the broader aspects of sustainability. The underlying issue is the extent to which organizations consider the long-term impact on the environment of their FDI projects. This is of great importance for a large and fast-growing economy, in a country with a high density of population.

The purpose of this paper is to develop a number of hypotheses for future testing. These hypotheses are here developed in very general terms. The testing of these hypotheses will require further clarification and definition of the variables involved and the development of suitable metric instruments to allow the variables to be measured. However, we believe that at this stage it is important to discuss the theory behind our hypotheses and explain why empirical research in this area would be of value.

### **Proposed Research Hypotheses**

The political background to foreign direct investments is one crucial factor influencing both the success and the long-term environmental impact of FDI schemes.

Because of China's unique social market political system and the continued influence of the state, it is of vital importance for firms to understand the Chinese political system and climate. This will be easier for organizations from countries which have a relatively similar background than for those which come from countries where governments tend to adopt a more liberal *laissez-faire* approach. Those organizations will have less experience of dealing with centrally planned economic systems, extensive regulation and public sector involvement in business ventures. They may also be more inclined to resent state interference and consequently less likely to develop a high degree of commitment to Chinese FDI projects.

This consideration leads to our first hypothesis, which is concerned purely with the commercial success of the project:

*H1.1: The success of a Foreign Direct Investment in China is directly correlated with the similarity between the political systems of China and the country of origin of the firm making the investment.*

The next hypothesis concerns the effects of political uncertainty on corporate planning. If there is a high degree of political uncertainty, it will be harder to assess the risk of adverse governmental action in the medium to long term. It will also mean that there is a high probability of frequent changes in government policy and regulations and therefore an increased probability that government actions at some time during the lifecycle of a long-term project will effectively curtail the project's usefulness to the corporation.

As a result, political uncertainty will mean that less consideration is given to long-term goals and long-term planning as there is less chance of the corporation continuing to be involved in the project in the distant future. The corporation can therefore be expected to give more consideration to short-term goals (whether in terms of profits or learning experience or anything else) and less consideration to sustainability. This gives rise to our third hypothesis:

*H1.2: The priority given to sustainability in the planning of Foreign Direct Investment projects in China is negatively correlated to the degree of political uncertainty in China.*

The next set of hypotheses concerns the impact of culture on sustainability. Previous studies of business practice and regulation based on Hofstede's four cultural dimensions (e.g. Salter and Niswander 1995, Margerison and Moizer 1996, Lagrosen, 2003, Matveev and Nelson 2004, p.259, Sims and Gegez 2004, p.263) have shown the particular importance of Hofstede's dimension of Uncertainty Avoidance (Hofstede 2001, pp.145-208) in explaining managerial behaviour and regulation.

It may be expected that uncertainty avoidance will have some effect on attitudes to the environment and sustainability. A high degree of uncertainty avoidance may also lead to a reduced interest in long-term effects which cannot be quantified with certainty. In addition, it may lead to reluctance to make a long-term commitment to an FDI project and this in turn will lead to a loss of interest in the long-term local impact. Because of this, it is suggested that Uncertainty Avoidance will have a negative impact on sustainability planning.

The following hypothesis is therefore suggested for investigation:

*H2.1: The priority given to sustainability in the planning of Foreign Direct Investment projects in China is negatively correlated with the level of uncertainty avoidance in the country of origin of the firm making the investment.*

As explained above, testing this hypothesis may well ultimately reveal that a positive rather than a negative relationship exists, which makes empirical testing all the more important.

Another of Hofstede's cultural dimensions which may have an impact on sustainability is what Hofstede describes as "Masculinity versus Femininity" (Hofstede 2001, pp.279-350). Among the attitudes examined by this are attitudes towards personal risk, with people in "masculine" societies being willing to take risks in order to increase their opportunities, while people in "feminine" societies being risk-averse and security-seeking (Hofstede 2001, p.282). It is suggested that a personal risk-taker will be less concerned with overall sustainability issues as

these have an uneven effect on personal outcomes. The personal risk-taker will be more willing to contemplate taking an environmental risk for two reasons. Firstly, there is the chance that the environmental damage may not happen or that the benefits will outweigh the damage caused. Secondly, on an individual level, if damage does occur, individuals will probably be affected in different ways and to different extents. A risk-sensitive person will do everything possible to reduce the risk of environmental damage and non-sustainability because of the possible personal consequences if the damage occurs. We therefore propose the following hypothesis in relation to cultural attitudes to personal risk-taking:

*H2.2: The priority given to sustainability in the planning of FDI is negatively correlated with a high degree of approval of personal risk-taking in the country of origin.*

A third set of hypotheses concerns the effects of financing on attitudes to sustainability. Companies' financing may come from a variety of sources but funding can generally be divided into three categories: shareholders' equity, loan finance and government funding.

The different parties responsible for providing funding will have different objectives and different timescales for meeting them. Equity investors hold permanent shares in the company. Ownership of the shares is not permanent but the shares themselves are. If the company and the shareholder both have profit making as their objective, this forces them to take a longer term perspective. A focus on short-term profits only, at the expense of long-term profits can result in a lower value for future income streams overall. The situation is quite different for loan creditors. Their interest in the company is limited to the timescale of the loan finance they have provided. It therefore follows that we should expect companies which raise most of their funding from interest-bearing loans to take a more short-term view and be less interested in sustainability than companies which have a high proportion of equity funding. We therefore propose the following hypothesis:

*H3.1: The priority given to sustainability in the planning of FDI is negatively correlated with the gearing of the company making the investment.*

The effects of government funding are not as easy to predict. However, the timeframes within which governments operate are potentially important regardless of these issues. A government will not generally be interested in the effects of its actions in the distant future, because of the problems that governments face in controlling distant events and because of the difficulty of claiming or benefiting from political credit if the effects of their actions are not felt before they leave office. The result is that governments which do not feel that they have a secure long-term future or are uncertain about their ability to carry their policies into effect consistently into the long-term will not be interested in the long term. They will therefore lack interest in sustainability issues, regardless of whether they regard the natural environment as an important issue or not.

However, this only matters for an FDI project if the government is a significant partner. Our second financing hypothesis is therefore more complex. It is not the degree of concern for sustainability itself which can be expected to be correlated with political stability but the extent to which this degree of concern for sustainability is correlated with the level of government funding for the FDI project.

In other words:

$$S = \alpha_1 + \beta_1 G \quad (1)$$

and

$$\beta_1 = \alpha_2 + \beta_2 U \quad (2)$$

where S is a measure of the priority given to sustainability in planning an FDI project, G is a measure of the extent of home government funding for the project and U is a measure of political uncertainty in the home country. We can express this as follows:

*H3.2: The correlation between the priority given to sustainability in the planning of FDI projects and the extent of funding by the government of the country of origin is negatively correlated with the degree of political uncertainty in the country of origin.*

## CONCLUSIONS

This paper has attempted to develop some hypotheses for the study of the effects of cultural and political factors on the sustainability of FDI projects in China.

It is suggested that future research in sustainability must take account of the impact of FDI projects in major emerging markets, as these projects have a potentially serious aggregate effect on the environment, in terms of depletion of the earth's resources, pollution and the destruction or alteration of ecosystems. It is therefore imperative that some research is carried out on the factors which can influence the degree of prominence given to sustainability issues by decision-makers in FDI projects, especially at the corporate level. By understanding these influences, policy-makers will be in a better position to encourage sustainable development and long-term economic development and social welfare.

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