

REGULATORY COMPLIANCE: PAPER TIGERS IN CHINA

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Abstract

Managing employer social protection compliance is a particularly difficult regulatory issue in emerging economies like China. Utilizing empirical evidence generated by eight case studies conducted in Shanghai this paper details how employers respond to attempts by the state to manage their social protection behavior and why social insurance is deemed to be a significant operational cost that is likely to be avoided or evaded. The picture presented builds on recent statistical analysis of Chinese business compliance behavior and reveals insights difficult to generate due to managers' concerns that admitting to non-compliance may cause them difficulties with employees and/or the state. This study argues that 1) Shanghai managers will tend to engage in non-compliance if this is deemed a strategic option that can raise their competitive edge in spite of concerns about the need to maintain an image as good social citizens; 2) that regulations need to be uniformly enforced on all firms if all employers are to be expected to comply; and 3) that firms incorporate the costs and benefits associated with social protection into their labor management strategies through a conscious policy of internal segmentation.

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A competitive social protection regime is a vital part of the institutional framework that nations need to construct if their populations are to have the level of security needed to sustain support for market openness. By social protection we mean the regime of policies, programs and regulatory structures that all developed nations have instituted, in one form or another, to reduce individual and collective vulnerability. For employees, relevant risks include impoverishment due to old age, pregnancy, poor health, injury, and unemployment. Given there is a real and present danger, competition will induce employers to evade their social responsibilities and thus, governments must enforce compliance. Managing this need is a difficult regulatory¹ issue for all governments (Gillion, 2000) and is a major problem for Chinese regulators who in 2000 reported only 18 per cent of private firms fully met their mandated obligations (Zhu and Nyland, 2004, 2005).

One factor rendering the study of employer compliance a difficulty is that scholars are seldom able to attain firm specific data on this aspect. Enterprise managers rightly fear that to allow researchers to access firm specific data may uncover conscious or inadvertent wrongdoing and lay the firm open to prosecution (McGillivray, 2001). In this paper we focus on employer social insurance compliance in Shanghai a city in which statistical analysis has revealed a high level of employer free-riding and a clear association between non-compliance and core features of the firm (Nyland, Smyth and Zhu, 2006; Maitra, Nielsen, Nyland, Smyth and Zhu, 2005). We build on this statistical analysis by reporting on eight case studies undertaken in 2004.

Our approach exposes important details not made apparent by the statistical analyses reported in earlier articles (Nyland, Smyth and Zhu, 2005; Maitra et al., 2005). These details lead us to argue that Shanghai managers will engage in non-compliance if this is deemed a viable strategic option even though they are concerned about their image as good social citizens; want regulations enforced on all other firms if they believe they must comply; deem social insurance to be a significant operational cost; and segment their labor force to optimize the costs and benefits generated by state social insurances. It is also concluded that while a number of the associations statistical analysis identified between firm type and employer behavior support the claim that multinational enterprises (MNEs) are particularly bad performers, it needs further investigation. Part one sketches the regulatory compliance literature, part two outlines the literature regarding regulatory compliance in China and part three discusses how details the eight cases study firms responded to the state's social insurance regulations and the nature of the association between employer behavior and the characteristics of the firm.

REGULATORY COMPLIANCE

Employer non-compliance occurs when firms do not pay or elect to underpay mandated contributions (Bailey and Turner, 2001). The International Labor Organization (ILO) reports "compliance problems, whilst varying in complexity and intensity, are very common and social security schemes must take measures to ensure that contributions are collected" (ILO 1998, p. 93). To shed light on the intricacies of compliance researchers have put forth in both theory and findings, a selection of which are reviewed in the following section. Figure 1 provides an illustration of the various theories and findings.

Figure 1 about here

Early theorist contended that individuals would weigh the expected outcomes of their non-compliant activities against the risk of being caught and punished (*pathway E* → *CP*). Therefore, as a deterrent, penalties were considered the important factor in compliance likelihood. This economic approach was the focus of research until the 1980s. Greer and Downey (1982)

postulated that there were four factors with positive and negative influences on compliance behavior. Two dealt with individual forces: normative – personal beliefs (ethical, moral, and political) (*pathway F → CP*); and calculative – personal cost and benefit (*pathway E → CP*). The remaining two factors represented organizational forces – normative – organizational norms and culture (*pathway F → CP*); and calculative – organizational costs and benefits (*pathway E → CP*). This conceptualization recognized that the environment in which the organization or individual was situated affect the forces that either drove or restrained compliance behavior (1982) (*pathway [H]² → E/F/G³ → CP*). As can be seen, early theorists focused on the relationship between organizational/individual factors (enforcement; moral and ethical fortitude; and public response/social action), possible illegitimate gains and compliance outcomes (*pathways → E or F or G → CP or NCP*).

The fact that regulatory control (monitoring, surveillance and enforcement) exerts a great deal of expense has been reiterated by numerous authors (Baldwin and Cave, 1999; Cason and Ganadharan, 2006; Sutinen and Kuperman, 1999). Greer and Downey (1982) highlighted that poorly conceived and/or designed regulations can create problems that enforcement of the regulations/policies can become neither cost effective nor efficient (*pathway A → NCP*). Thus, by enacting poorly conceived and/or designed regulations/policies, governments ‘can obscure the desirability of pursuing goals of social responsibility behavior’ (Greer and Downey, 1982, p. 448). They and other authors have rightly argued that to design effective and efficient regulations one needs to understand why businesses comply or choose not to comply (Farnsworth and Holden, 2006; Greer and Downey, 1982; Sutinen and Kuperman, 1999).

American authors discussed a regulatory environment fraught with budget constraints of enforcement agencies and the American courts refusing to impose stiff penalties on violators in fear of economic fallout (Baldwin and Cave, 1999; Greer and Downey, 1982; Harrington, 1988) (*pathway B → E → NCP*). This concept brings into play the relationship between state capacity and organizational factors (*pathways B or C or D → E or F or G → CP or NCP*). In an analysis of American environmental regulation compliance, Harrington (1988) found that a 90% compliance rate occurred despite a very low occurrence of inspection and financial penalties were very rarely assessed. To explain this phenomenon he used game modeling to test whether compliance was due to other factors such as the fear of bad publicity. His conclusion was that a static economic model (*pathway E → CP*) (i.e. Becker, 1968) did not explain compliance; however, an adaptive/dynamic model encompassing external factors provided a plausible explanation (Harrington, 1988) (*pathway E/F/G → CP*). This model was tested in laboratory experiments and the same findings arose (Cason and Ganadharan, 2006). Cason and Ganadharan (2006) however, purposed that decisions might often be boundedly rational. In other words, the individual's decision is not based solely on finding the optimal financial solution (*pathway F → CP*).

Sutinen and Kuperman (1999) focused on psychology and sociology theories to explain compliance behavior. Cognitive theory and normative perspectives were used to explain compliance behaviors based on moral grounds (*pathway F → CP*). Social learning theory and instrumental perspectives clarified the role of external factors such as social influence and affects on tangible assets on compliance behavior (*pathway E/G → CP*). A group of British researchers' findings verified the existence of normative and social forces on compliance (*pathway G → CP*) and found that geographic location made a difference in compliance behavior; context mattered (Hatcher, Jaffry, Thébaud and Bennett, 2000) (*pathway [H] → E/F/G → CP*). Since then research has uncovered other factors that affect compliance: compliance by one firm will affect compliance strategies by another (Decker and Pope, 2006); national culture (Chen, et al., 2006); organizational culture (Gebler, 2006); (*pathway [H] → E/F/G → CP*) and consumer pressure (Stafford, 2007) (*pathway G → CP*).

Regulatory Compliance in China

Economic reform ushered in by China has brought prosperity to China; however, accompanying economic reform was the need to reform policies and regulations of non-economic variables.

Research on policy reform has covered re-employment policies (Solinger, 2002); religion (Leung, 2005; Potter, 2003); environmental policies (Ma and Ortolano, 2000; Schwartz, 2003); coal mining health and safety policies (Andrews-Speed et al., 2002; Andrews-Speed, Yang, Shen and Cao, 2003; Creedy et al., 2006; Wang, 2006; Wright, 2004, 2007); occupational health and safety (Pringle and Frost, 2003); policy response to SARS (Schwartz and Evans, 2007); telecommunications (Harwit, 2007); cadre management (Edin, 2003); social welfare focusing on children (Adams and Hannum, 2005); social welfare programs for the elderly (Wu, Carter, Goins and Cheng, 2005); and social assistance programs (Leung, 2006). From this literature common themes emerged regarding enforcement and compliance.

The reality of economic reform was that amid successful policies changes were ineffective and inefficient policies/regulations and ineffective and inefficient enforcement (Solinger, 2002). Policies were labeled ambiguous (Wright, 2007), poorly designed (Ma and Ortolano, 2000), confusing and conflicting (Edin, 2003; Ma and Ortolano, 2000; Pringle and Frost, 2003), and unclear (Andrews-Speed et al., 2003; Pearson, 2007). In the area of social protection policy Leung (2006) claimed that interpretation differed between regulatory bodies and end users (*pathway A* → *NCP*).

The most common reason given for non-compliance was economic gain (Andrews-Speed et al., 2002; Ma and Ortolano, 2000; Pearson, 2007; Pringle and Frost, 2003; Schwartz, 2003; Solinger, 2002; Wang, 2006; Wright, 2004, 2007). Authors argued that the economic gain manifested non-compliance behavior at the enterprise level and was encouraged at the local government level. In the case of coal mines, local governments were more concerned with economic repercussions than they were with the growing number of deaths caused by accidents which were a result of flagrant non-compliance of safety regulations (Andrews-Speed et al., 2002; Andrews-Speed et al., 2003; Pringle and Frost, 2003; Wang, 2006, Wright, 2004, 2007). In a study of environmental policies it was found that local governments were less concerned with pollution than they were about economic prosperity (Schwartz, 2003) (*pathway E* → *NCP*).

Another factor encouraging non-compliance arose from conflict of interest. Conflict of interest developed from primarily two sources: government officials owning shares of business facing regulatory constrictions or non-compliant firm generated large revenues for local government (Andrews-Speed et al., 2002; Ma and Ortolano, 2000; Schwartz, 2003; Wang, 2006; Wright, 2004, 2007). Officials were reluctant to use financial penalties due to undesired economic consequences such as firm closures resulting in unemployment and appearing unfriendly to investors (Ma and Ortolano, 2000; Schwartz, 2003). A further economic factor facilitating non-compliance took the form of personal gain through corruption. Several authors noted that corruption was a deep rooted problem that was evident at many levels (Pringle and Frost, 2003; Schwartz, 2003; Wright, 2004, 2007). Wedeman (2004) argued that corruption, due to the increased prosperity, has intensified in the ranks of senior management (*pathway A* → *B* → *E/F* → *NCP*).

Compounding the economic problems of non-compliance was the unwieldy bureaucratic nature of the Chinese government. Its multi-layered structure (see Figure 2) brought into play too many agents, which provided avenues for misinterpretation, conflict of interest, more possibility of corruption and lack of clarity regarding responsibility (Andrews-Speed et al., 2002; Andrews-Speed et al., 2003; Ma and Ortolano, 2000; Pearson, 2007). Leung (2006) found that interpretation of policy varied according to local governments, the use of *guanxi* (social connections) to avoid regulations or to gain favorable decisions and corruption were all used to circumvent policy (*pathway A* → *B* → *E/F* → *NCP*).

Figure 2 about here

In a review of regulatory reform in China, Pearson (2007) points out that it was difficult to separate government from business for two major reasons. First, state-owned enterprises were perceived to receive preferential treatment. Second, privatized state enterprises often were controlled by

high ranking officials who had connections with the regulatory agencies. Studies of policy reform in Chinese coal mines reflect an obstacle to compliance was interference of local government for either economic or personal (ownership) reasons (Andrews-Speed et al., 2002; Andrews-Speed et al., 2003; Pringle and Frost, 2003; Wang, 2006, Wright, 2004, 2007). Officials would routinely ignore issues of non-compliance with state regulations even with the knowledge that failure to comply with the safety policies may result in serious accidents (Pringle and Frost, 2003; Wang, 2006, Wright, 2004, 2007) (*pathway [H] → B → E/F → NCP*).

Enforcement agencies were termed ‘toothless tigers’ (Wang, 2006). This was for several reasons. First the conflict of interest of government officials created inequities and inequalities in both interpretation and enforcement, which resulted in the lack of support for enforcement (Andrews-Speed et al., 2003; Ma and Ortolano, 2000; Schwartz; 2003; Wang, 2006; Wright, 2007). Poorly designed policies resulted in confusion and misinterpretation (Edin, 2003; Ma and Ortolano, 2000; Pringle and Frost, 2003; Solinger, 2002). In some areas enforcement of the policies required a given level of expertise (e.g. environmental regulations) and there was an insufficient supply of knowledgeable regulators (individuals with such knowledge garnered higher wages from the private sector) (Schwartz; 2003). Finally, many enforcement agencies lacked the fiscal resources to enforce regulations on a wide scale (Andrews-Speed et al., 2003; Ma and Ortolano, 2000; Schwartz; 2003; Wright, 2004) (*pathway A → B → E/F → NCP*).

To combat the lack of financial resources and the fear of economic consequences of financial penalties state agencies employed shaming tactics to encourage firms to comply (Ma and Ortolano, 2000; Solinger, 2002) (*pathway C → F/G → CP*). These were considered pragmatic enforcement strategies given the Chinese cultural traits of *guanxi* and the loss of face (Ma and Ortolano, 2000). The influence of culture values on compliance behavior was ratified by Chen and colleagues (2006) in a study comparing three different countries (Hong Kong, Poland, and the United States). Changing cultural attitudes was highlighted as a possible compliance technique (Potter, 2003; Schwartz, 2003). Schwartz (2003) pointed out that the Chinese public’s view of pollution has changed over the last decade. According to Schwartz’s research one can credit the reason for the change to increased attention given environmental issues by non-governmental organizations, the media and the Environmental Protection Bureau’s education units. However, the diversity found in the thirty Chinese provinces created significant social, political and economic challenges to regulation enforcement (*pathway [H] → {C + D}⁴ → {F + G} → CP*) (Andrews-Speed et al., 2002).

A final theme that ran through a great number of the research findings was that of the impact of state capacity. State capacity was defined by using Skocpol’s definition – the ability of states to implement official goals, especially over opposition of powerful social groups, or in the face of difficult economic circumstances (1990, p. 9). From the above review it is clear to see that the three components were affected. First, human capital – researchers pointed out that enforcement agencies lacked man power and knowledge to act. Second, fiscal strength – a common observation was the lack of financial resources available to regulatory agencies. Finally, third, reach/responsiveness – the degree of influence of the state to implement regulations was affected by social and economic factors as well as the cumbersome bureaucratic structure of the government. These findings were verified by Schwartz’s (2003) study of environmental regulatory agencies, Edin’s research on cadre management reform and Wright’s (2007) review of coal mine closings policy (*pathway B/C/D → E/F/G → NCP*). Thus one can see that policy formulation, state capacity, moral and ethical, social and economic, variables were at play in compliance behavior. The next section will review social protection in Shanghai and our statistical analysis of data supplied by the Shanghai Bureau of Labor and Social Security (SBLSS).

Social Protection in ‘Greater Shanghai’

Nyland et al. (2005) and Maitra et al. (2005) have been able to confront business compliance behavior more directly than have earlier studies because they have access to a unique set of firm-specific, state audited data. This data set has been generated by the SBLSS as part of the

Bureau's effort to construct a market-oriented social protection regime. With SBLSS assistance, Nyland et al. (2005) examined 2001 data for 2,200 randomly selected firms that specified whether individual employers paid less than, more than, or exactly the prescribed premium, the amount of underpayment or overpayment, the industry in which the firm operated, ownership type, and the number of employees. Analysis of this data enabled the authors to both identify the level of compliance and explore the association between employer social protection behavior and key features of firms. They found a high level of non-compliance, that is, 71 per cent of the audited firms paid less than the prescribed social insurance, 4.7 per cent paid the exact amount and 24.3 per cent paid more than the required minima. It was also found that: (1) large firms are less likely to pay social security contributions in full or provide supplemental insurance; (2) high industry risk is associated with a high compliance; and (3) MNEs have a high level of non-compliance. Extending this contribution, Maitra et al. (2005) drew on SBLSS data from 2001 and 2002 to determine why many firms choose to comply with the law given penalties for non-compliance are weak. Utilizing a repeated game model they argued this behavior reflects employer desire to signal their good intentions and if previously caught signal their willingness to comply in the future. In this paper we build on these statistical contributions by reporting how employers in eight Shanghai firms perceive state social protection policies, how they have responded to the associated regulations, and the nature of the association between firm characteristics and employer behavior. The next section provides the context for this effort by sketching the character of the Shanghai social protection regime and by specifying our research questions.

Marketization of China's economy has gone hand in hand with the restructuring of the nation's social protection system. Whereas the pre-market welfare regime was firm based and funded, the market-oriented social protection system currently being developed involves a range of 'social insurances' funded jointly by employees, employers and the state. The social risks insured in Shanghai relate to old age, unemployment, sickness, injury, and maternity. However, not all residents can access the full range of entitlements as there are four distinct models of insurance. The first model, the urban insurance scheme or the 48 model is available to employees with a Shanghai registration (local non-agriculture residents). Employers contribute 37% of the payroll and employees contribute 11% of their salary (SBLSS 2004, p. 23) = 48%. If the average wages are less than 60% of Shanghai's average wage, the insurance obligations are still evaluated at equal to 60% of average city wages. However, if the average wage is greater than three times city average, the firm's social insurance obligations is capped at three times the average. Tax incentives are offered to encourage firms to purchase employee supplemental commercial insurance.

The second model is the 25 + X model, which covers small cities and townships. This is designed for local farmer-turned worker residents (i.e., registered residents in the towns of the greater Shanghai region outside the city proper). It was primarily introduced to provide for the needs of the many former farmers who lost their land due to the expansion of Shanghai. Employers are required to pay 25% which is based on a contribution base of 60% of the average city wages and an X contribution that is left to enterprise bargaining. Employees need not pay anything unless the contribution is required by a local town council (mainly for medical treatment). Again, employers and employees encouraged to top up their contribution via tax incentives.

The third insurance scheme is the 12.5 model, which is designed for migrant workers. The premiums are levied on a base 60% of city's average wage and employers must pay 12.5% of that base. For outside construction teams the rate is 7.5% (covers work-related injuries, hospital treatment, and pension but does not cover for maternity or unemployment).

The fourth model is the rural insurance scheme, which is compulsory for enterprises registered in rural areas and employees. However it is not compulsory for individuals from so-called 'sole farmer families' (families with all members working on the land) and individuals from sole farmer families choose whether or not to contribute. The enterprise has to contribute to rural social security fund (15% of average income per capita in the local town X number of employees). Employees contribute 5% of average income per capita in the town. The pension provided by rural

model consists of two parts: 1) basic monthly age pension and 2) mean savings from individual account. Since the pension is based on a per capita basis it varies, depending on prosperity of district, amount in each town's rural insurance fund and number of pensioners (varies from 75 RMB in least industrialized area to 600 RMB in most developed area).

Having introduced the four Shanghai programs we now proceed to clarify how employers perceive and respond to state social protection policies and the nature of the association between firm characteristics and employer behavior. To achieve these goals we investigate the following:

Research question 1: How have employers perceived and responded to the social protection policies and regulatory structures established by the SBLSS?

Research question 2: What enterprise features are associated with employer compliance behavior?

METHOD

Given the difficulty of gaining firm-specific data, researchers have tended to embrace the method that Marx (1867) pioneered when analyzing employer responses to social protection reform, that is, they have relied on deductive analysis and/or macro-historical case studies. Mares (2001, 2003) and McGillivray (2001), for example, utilized these methods to argue differences in employer compliance behavior tend to be influenced by individual firm's skill profile, size and employee risk incidence.

In order answer why firms chose a non compliance strategy a qualitative methodology was chosen. Case studies were chosen for several reasons. First, as a qualitative method, case studies focus on answering 'how' and 'why' type research questions (Creswell, 1998; Yin, 2003). Second, a multiple case study design allows either replication or comparison. For this project the multiple case study design was utilized to capture the differences between organizations. Third, due to the sensitive nature of the research topic the researcher needs to develop an atmosphere of trust that facilitates open discussions. The use of in-depth interviews as the primary data collection method assisted in establishing that atmosphere.

The fourth reason was that the area of non-compliance in China is a relatively new phenomenon. Yin states that a cases study "investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident (2003, p.13). In this situation, non-compliance is definitely a contemporary issue and the boundaries (the 'why') have not been clearly defined. For all these reasons the case study method was deemed appropriate.

The case studies were generated through the alumni of an Australian university in firms in Shanghai who were contacted via e-mail. Since the purpose of the multiple case study design was a comparative analysis it was essential that a variety of factors were captured. The eight firms characterized differences in industry, ownership type, and size. The firms represented manufacturing, investment, real estate, and pharmaceutical industries. Ownership types included three privately owned enterprises (POEs), two wholly owned foreign enterprises (WFOEs), two share holding enterprises (SHEs), and one state owned enterprise (SOE). Aside from the two SHEs one of the POEs and the SOE were listed on the Shanghai stock exchange. It is important to note that in either case the amount of shares publicly traded was below 50 per cent. Table 1 provides a further breakdown of the eight case study firms' characteristics. Semi-structured in-depth interviews were conducted with HR staff members, HR managers, and members of senior management. A total of 16 interviews were conducted in Chinese, and then transcribed into English.

Table 1 about here

RESULTS AND DISCUSSION

Research Question 1

The findings have shown that while there is great diversity in the way Shanghai firms respond to mandated social protection legislation there are commonalities and patterns of enterprise behavior. In response to the first research question regarding how employers perceived and responded to the social protection policies and regulatory structures established by the SBLSS five responses stood out: 1) construction of an effective policy; 2) level the playing field; 3) cost control; 4) firm reputation; and 5) recruitment and retention tool. The first two points reveal the firms' perceptions of the policy and enforcement; whereas, the last three points focus directly on the issues that arise from the policy that affect performance and image.

Construction of an Effective Policy

The first response, construction of an effective policy, reflected the participants' perception of the current policy. Most of those interviewed believed the policy was ineffective and highlighted two problems. For the first problem, managers of the three firms (F6, F7, and F8) that were audited and found non-compliant blamed their failure to comply on the interpretation of the wording of the policy. F6 and F7 claimed the policy's definition regarding wages were 'vague'. This claim seemed to have some basis since F6 was awarded a medal by the Shanghai municipal government for being the best employer in the private sector the same year it was found non-compliant. The HR manager of F7 further reported that the firm did not purchase supplementary insurance as neither employer nor employees felt it was justified as the SBLSS had not clarified what individuals would receive upon retirement. The HR manager in F1, a Swedish subsidiary, concurred with the interviewees of F8 and added that the policies were 'complex'. F3 placed the blame on the interpretation of the policy by SBLSS and called it 'unfair'.

F8, who was caught twice (1999, 2003), said the policy 'lacked clarity'. F8 had been the largest SOE of its type in China under the planned economy. Approximately 1,150 employees were retrenched in an effort to survive leaving 2400 staff with 1,400 being core employees and 1,000 peripheral. Salaries and bonuses for these two groups of employees differ but social insurance mandated by the government is the same as F8 did not deem the skill allowance to be part of the wage when calculating insurance dues. Employees had complained about this policy, which led to the two incidences of being caught. Though caught twice, the management denied the firm was non-compliant insisting the failure to meet their obligations was due to the lack of clarity that characterized relevant regulations.

The second problem was that firms had difficulty with the notion of progressive taxation and lamented the fact that though they had to pay higher premiums than many other firms their employees did not receive a pension greater than the norm. Managers in F2 and F4 were concerned there was no link between contributions and benefits. Given the average wage, the F4's premium was three times the city average while the benefits employees received were the same as those where firms paid the minima.

Level the Playing Field

Common to virtually all firms was the second response that there was not a level playing field. Managers in all firms believed the state must compel every other participant in their industry to fully meet their obligations and that this requirement was not being adequately met. That this response was forthcoming even from firms that non-comply in regions where enforcement is largely non-existent suggests this commitment is often motivated by a desire to ensure competitors do not gain an edge and/or by a desire to self-justify non-compliance. F2 and F4 were particularly vocal

regarding a level playing field. The General Manager (GM) of F4 believed it was 'imperative' that all firms be compelled to meet their responsibilities and the HR director of F2 emphasized the need to 'contain evasion by Chinese firms'. For F4 a difficulty was that because the state had a high level of equity the managers were limited in their capacity to emulate cost minimization activities claimed to be common in the private sector. All interviewees held the state must construct an effective social protection regime while leaving control of some areas of insurance in the hands of individual firms. This they felt was necessary to create a fair and equitable social protection environment that would facilitate the voluntary compliance of firms.

Cost Control

All managers considered social insurance expenditure to be an issue of importance to the profitability of the firm. Given the mandated costs can add as much as 37 per cent to the total wage bill and voluntary insurance can increase this figure the concern is not surprising. Nor, given the magnitude of these costs is it surprising some firms evade their responsibilities in order to gain a competitive advantage. Firms attempted to take advantage of the four models of insurance available to different employee categories. F4 was seeking to restructure the remuneration package in order to reduce the wage component and hence, the required insurance premium. F3 provided a range of insurance packages for its employees with the prime factor determining what the individual receives being their household registration (*hukou*), skill level, local regulations, and the vigor with which officials enforce regulations.

F2 applied the strategy of hiring temporary employees to reduce costs. The firm paid mandated insurance premiums for all employees apart from temporary workers who were hired through employment agencies and the latter were responsible to insuring the employee. For F3 cost minimization was also attained by restricting coverage. In the same vein as F2, F3 commonly employed low skilled migrant employees as casuals in order to contain insurance costs. The latter practice was justified on the grounds that social insurance was not portable across regions and in many places it was not compulsory to purchase social insurance for these workers. In brief, F3 senior managers deemed cost control to be fundamental and hence, paid social insurance premiums in full only when it was absolutely necessary.

F5 management, within the mandated rules, took great care to minimize the costs associated with insurance. Accordingly, the level and form of insurance provided employees differed markedly across the workforce. The preferred blue collar employees were local off-farm workers as they are covered by the Shanghai rural area social insurance policy. Second choice was external migrant workers, who would accept a low wage package and very few benefits. Also appealing were state retrenched employees as their social insurance was normally paid by their former firm and they provided their own accommodation. However, as these people often had higher expectation than migrants the firm would employ them only if they were skilled and had the work experience required of supervisors. These elite workers were provided supplementary insurance with the level being determined by their performance.

Before F6 was publicly listed the staff were covered by the Shanghai rural area social insurance program as 90 per cent of employees were farmer-turned-workers employed working in a newly urbanized area. This policy required a low annual payment (about 1,000 RMB per person) and only provided for a small pension. When F6 employed technical and managerial staff from the urban area, it had to offer them Shanghai urban social insurance. In order to change its image as a rural, low technology TVE, F6 adopted the Shanghai urban social insurance program for all local employees. As its salary level was below the city average, the firm was able to use 60 per cent of the city average as its baseline. Nevertheless, the firm's social insurance contribution quadrupled and the management felt compelled to segment the workforce. Local workers remained covered by the city program and this was supplemented by purchasing commercial coverage from the Shanghai Workers' Mutual Association for an annual fee of 30 RMB per person, which covers 60 per cent of hospitalization expenses. By contrast, the employment of migrant workers from beyond the local area was increased and these employees were provided only the rural social insurance supplemented by a small commercial program. Workforce segmentation was extended when the

25+X model was introduced. To reduce insurance expenditure the firm determined most employees subsequently recruited would be covered by township insurance with no X component except for highly skilled professionals and senior managers.

F8 concurred with the other firms in that it was trying to ensure all requirements were met but found this to be a significant burden. However, like many state enterprises it was struggling to survive in a market environment due to overstaffing, low productivity, and the loss of tariff protection. Given its heavy debts and decreasing profitability (the firm paid 36.5 per cent social insurance plus a 7 per cent housing allowance) F8 cut costs through liberal interpretations of the policy, which lead to complaints and subsequent non-compliance fines.

Only F1 acknowledged payment was not an excessive burden since the high average wage and the cap on dues meant insurance premiums were only 20 percent of total payroll which was much lower than the 37 percent proportion normally paid by most firms. All staff received supplementary medical insurance was provided to employees at an annual cost of 1,800 RMB per person except for a small number of machine operators whose former employer had agreed to continue paying their pension and medical insurance in lieu of a lump sum separation payment. Thus, F1 managed cost by hiring retrenched employees.

A lower percentage of managers admitted engaging in non-compliance than was revealed by the statistical studies of audited data. However, given that managers were being asked if they consciously break the law the fact that some interviewees admitted they do engage in non-compliance, suggests this is a common response to social policy when and where managers are convinced free riding is a viable cost reduction strategy.

Firm Reputation

A third common response was explicit and repeated vocalization of the claim that the firm is a good public citizen. With one exception (F3), even employers who were serial non-compliers did not admit their firm had failed to fulfill its moral duty. Rather, those caught sought to shift the blame on to others and most notably on to the SBLSS which was charged with providing inadequate information and poor definitions. Given the Bureau has gone to pains to ensure firms and employees have a clear understanding of what is mandated, this response should be treated with a deal of cynicism. This is emphasized by the fact that there exists in Shanghai numerous consultancy firms capable of providing advice and assistance on employee insurance issues.

The HR manager of F1 observed the parent company insisted that its subsidiaries must fully meet mandated social insurance requirements as full compliance was seen to be a social obligation. This attitude reflects the Swedish culture of social protection as an obligation (Haas, Allard, and Hwang, 2002; Styhre, 2004). F2's managers considered compliance with Chinese regulations vital to a good reputation. The head of the HR department in F5 observed that the firm was building its reputation in order to become publicly listed and hence, had to comply with all requirements relating to social insurance. The management personal interviewed in F6 insisted, although charged with non-compliance, that it adhered to the government's regulations and wished to be recognized as an employer of choice.

The GM of F8 denied that state employers commonly failed to comply with social insurance obligations in order to maximize returns. As a senior manager working for decades in a large SOE, he believed concern for employees' social security needs was still manifest in the public sector though he acknowledged benefits had been curtailed (no more free medical treatment or free education for employees' children).

The managers interviewed in F8 asserted they were also motivated to provide for employee needs by the 'carrot and stick' methods employed by the SBLSS. The 'carrot' was the Bureau's practice of holding up for public applause 'civilized organizations' (equivalent to 'employer of choice' or 'best employer') while the 'stick' was the public shaming of firm's found guilty of social insurance

evasion. To add an extra pressure the hot line SBLSS sustains enabled employees to report employer non-compliance.

Recruitment and Retention Tool

A fifth common response was a clear tendency to utilize employee insurance as a recruitment and retention tool. The four models of insurance dividing urban and rural workers created as an F6 senior manager called it a 'one firm, two systems' policy and all interviewees agreed the township insurance program not only increased the firm's capacity to control costs but allowed for the design of effective recruitment and retention programs.

The disparity of a higher premium yet the same pension as the norm was perceived as a hindrance to recruitment by the HR Manager of F2. The HR manager explained that if the base contribution was the same for all enterprises the firm would have greater power to recruit high quality labor by offering commercial insurance and/or higher wages. To offset this F4 purchased both commercial superannuation and medical insurance for all employees with the level dependent on position and time employed. Commercial medical insurance was five times the base level and employees were also offered attractive housing allowances that could be cashed in if they remained with the firm for 5 years. The GM of F4 commented that commercial pension insurance was utilized as part of a longer term labor retention strategy since benefits do not materialize until employees retire.

Our study indicates that while Chinese employers use social insurance as a management tool they are very selective in identifying which segments of the workforce will receive benefits greater than what is mandated. Moreover, high wage firms would find attractive a non-progressive regime because they believe that if the same base premium was paid for all workers the employer would have a greater capacity to use benefits as a management control mechanism. The extent to which employers took care to segment the workforce when designing their insurance strategies stands in marked contrast to the minimal attention accorded employee insurances by labor economist and organizational behavior analysts. This was a response not identified in macro-historical and/or recent statistical analyses of employer insurance behavior because the data utilized in those studies has treated each firm as a 'black box' that is analyzed as an homogenous unit.

Research Question 2

In response to the second research question our case studies have highlighted three enterprise features that appear to have a significant influence on compliance behavior: 1) risk; 2) skill composition of the workforce; and 3) ownership form. Originally we had anticipated that firm size may affect compliance behavior but no clear pattern emerged. The largest firm studied admitted it engaged in non-compliance but this behavior was more a function of perceived risk than of firm size. Similarly, small firms were more likely to be motivated by a desire to attract skilled labor and desire to appear good citizens though the fact that small, low skill, low profit enterprises were not studied leaves the size issue somewhat moot.

Risk

Theoretically, where the workforce was subject to high levels of physical risk there was a greater likelihood that workers would be covered by relevant forms of social insurance. However, the risk factor that interviewees tended to emphasize was not the physical danger to the worker but the risk of getting caught for evasion. Many managers were of the view that their competitors were able to cheat with relative impunity and clearly accepted that if others were allowed to avoid their responsibilities in this manner it was only fair that they should be able to act likewise. In brief, management's perspective and presumably actions are influenced by the level of rigor with which the state enforces its regulations and the risk of being caught non-complying. It seems lack of strong enforcement not only curtails fear of exposure but also strengthens belief that non-compliance is morally just.

The case study interview participants broke risk down into four factors: reputation, cost, detection, and penalties. 'Reputation' referred to the firm's risk of losing their good public image which was

noted to assist them in the recruitment process. The 'cost' risk factor was determined by the level of competition, and maximizing return. 'Detection' referred to the perceived risk of being caught. Finally, 'penalties' was the risk associated with the assessment of punishment for non-compliance. To induce compliance through the 'reputation' risk factor SBLSS employed public commendation or shaming. Participants from five firms specifically discussed the reputation risk factor, which supports Harrington's (1988) statement that public image and compliance are related. In F2 and F5 the firm's managers considered compliance with Chinese regulations vital to a good reputation; thus their perceived risk focused on the need to build firm reputation. The preoccupation with building reputation eliminated the risk of non-compliance and as a result none of the three firms, F1, F2 and F5 had experienced any difficulties with local regulatory agencies. F6's and F8's management insisted that it adhered to the government's regulations and wished to be recognized as an employer of choice. However, what they termed as misinterpretation of the policy led to being caught for non-compliance. Thus, it was apparent that F6 and F8 countered the risk of a bad reputation with the need to reduce costs.

For the 'cost' risk factor firms evaluated the risk of being caught against the level of competition, and maximizing return. For example, senior managers deemed cost control to be fundamental in F3 and hence paid social insurance premiums in full only when it was absolutely necessary. In case study F7 the wish to remain competitive and cost control also influenced how the firm shaped their insurance policy. The GM of F8 denied that state employers commonly failed to comply with social insurance obligations in order to maximize returns. F8 was trying to ensure all requirements were met but found this to be significant burden given its heavy debts and decreasing profitability (the firm paid 36.5 per cent social insurance plus a 7 per cent housing allowance). Despite the GM's assurance the burden of debts and decreasing profits probably influenced their decision to take the risk of cutting costs through non-compliance as evidenced by their two incidents of non-compliance. All firms expressed that cost was a risk factor that they took into account within their compliance decisions and these were weighed against the damage to firm reputation, the likelihood of being caught, and the penalty assessed for non-compliance.

The importance of auditing was stressed as it was believed a great many firms would not comply with their obligations if convinced they could do so without detection. Firms observed that SBLSS monitoring was weak (F2), and the ineffectiveness and rigor of existing enforcement mechanisms allowed competitors to avoid payment (F5, F7 and F8). The managers of F8 complained many private employers did not contribute to social insurance and were able to do so because of the paucity of enforcement.

F6 and F8 reported that the risk of 'detection' was increased through the awareness of the hot line created by SBLSS that enables workers to report employer non-compliance. F6 had not heard of any complaints being lodged by their employees. F8 employees had complained and in 1999 the firm had been fined after being audited by the SBLSS and was caught again in 2002. Both F2 and F3 also noted that non-compliance did not have to be tolerated by the state because the Industrial and Commercial Bureau (ICB) has the capacity to assist the SBLSS regulate firm behavior through its control over business license renewals. Therefore, it was believed that SBLSS should work with the ICB to enforce universal compliance.

A manager from F3 admitted the firm underpaid or simply failed to pay social insurance in some regions of China. Where the firm was a major industry evasion was commonly facilitated by local government officials who feared the company would otherwise relocate. Where these circumstances prevailed, the F3 manager explained, the firm chose to be a free-rider. The belief that local government tolerated misbehavior by the private sector in order to assist local firms was reiterated by F4. F4 complained that the practice allowed local firms compete against firms in areas outside Shanghai but this tolerance was not extended to firms with significant state equity. The interviewees of case study F8 claimed firms could avoid being audited by utilizing connections (*guanxi*). The Human Resource Director of F5 was aware of firms that evaded their duties due to corruption. Whether it was due to fear of relocation or *guanxi* or corruption it reduced the perceived risk of detection and firms took advantage of the situation to reduce expenditures.

For F3, in contrast to other regions, the increased enforcement within the Shanghai area increased the risk of detection. They perceived the legal environment in Shanghai to be more rigorous than in many other areas, thus the firm met the city's requirements even though management believed the interpretation SBLSS placed on some regulations was unfair. Though willing to evade their responsibilities where the opportunity exists, the fact that the firm's managers deemed it wise to comply in Shanghai caused them to be forthright in demanding that local regulators make a greater effort to ensure all firms complied with their obligations.

The 'penalty' risk was assessed by firms to be low. F2 expressed that penalties were of marginal significance. Participants from F8 explained that if a firm was caught by the auditors SBLSS would issue a notice and discuss the problem with the organization which would be required to submit a report on the reason for non-compliance and asked to develop a strategy to ensure future compliance. However, they stated this effort lacked teeth as the firm would be penalized only if it failed to pay the required amount by an agreed time. For example, F6 was audited in 2003 and found to be underpaying its mandated contributions. Since the firm paid the due amount within the required period it was not penalized. This attitude reflects the findings of other researchers that governments and the courts are reluctant to impose harsh penalties that will cause unemployment (Harrington, 1988; Ma and Ortolano, 2000; Schwartz, 2003).

Skill Composition of the Workforce

The insurance behavior of all case study firms was informed by the need to attract and retain skilled labor. One enterprise (F4) did not differentiate amongst the different sectors of its workforce. However, they exception were seeking to restructure remuneration packages to increase its capacity to utilize insurance as a tool for recruiting and retaining skilled employees. A normative element was found to be present with several interviewees insisting it was unjust that the high premiums paid for high income earners do not generate increased benefits and hence increase the capacity of the firm to use mandated insurance as a labor management tool.

As previously discussed all the firms strove in some manner to reduce costs by the composition of their workforce. Compliance with the policy was formulated around interpretations of the act. Where organizations perceived a grey area they attempted to utilized liberal interpretations in order to reduce costs. It is debatable whether this strategy can be termed non-compliance or just testing the policy. What is not known was whether they applied the same strategy in other policy areas and were deemed compliant. However, what was evident was that the strategy was applied by the three firms (F6, F7, and F8) that were caught. Since the risk of penalties were regarded as low (if caught the offender merely paid the amount of shortfall), firms may have reasoned that the risk of utilizing liberal interpretations was worthwhile.

Ownership Form

In regards to ownership form, what was sustained was the statisticians' claim that state versus private ownership makes a difference to insurance behavior. Some evidence of this behavior arose from F4's management's complaint of the local government's preferential treatment of local private firms and their lack of tolerance towards firms with significant state equity. This may be one of the reasons firms with a high level of state equity appear to be less willing to engage in non-compliance and more likely to provide a range of benefits beyond that mandated by government. This appears to be a consequence of custom and practice, employee expectations, and the ability of the state to exert direct influence on management.

Nyland et al (2005) suggested that MNEs are more likely to engage in non-compliance; however, this was not supported by the evidence provided by these case studies. Indeed, the MNEs in our study placed great emphasis on the need to appear dutiful public citizens and were clearly influenced by the policies embraced by their home office. As the MNEs investigated were small in number we cannot generalize our findings but it may well be that a country of origin effect may be in operation. This possibility requires further investigation.

CONCLUSION

Our contribution was a demonstration of the integration of the various theoretical concepts of compliance regulatory behavior. The results we presented show the myriad of pathways that can result in compliance or non-compliance behavior. We support the concept that regulatory compliance or non-compliance is a dynamic process that involves multiple factors and actors. Our findings show that problems with regulatory compliance originate in the composition of the policy itself (see Figure 1) (*pathway A* → *NCP*). In the case studies this was evident in the manner in which several organizations interpreted the policy to their own benefit only to be charged with non-compliance due to that interpretation.

The next step dealt with the state's ability to implement the policy universally - state capacity. The state must have the human capital, financial means, and power (reach/responsiveness) to successfully implement the policy. Our findings indicate that China's social protection policy suffers from a lack of regulators (human capital), which is due to financial constraints. Also the findings show that the power of reach/responsiveness is diminished through bureaucratic levels of government, corruption, conflict of interest and fear of economic reprisal. Thus the policy is weakened in the perception of the organizations and the commonly chosen pathway was *B* → *E* → *NCP*. The Chinese regulators did attempt to increase compliance through public shaming but this had little effect (*pathway A* → *C/D* → *F/G* → *NCP*). The reason for the only partial success of the shaming strategy may lie within culture. As shown by F1, where a culture of obligatory social welfare existed, compliance with social protection was not a problem. Schwartz (2003) pointed out that the cultural attitude towards pollution was reshaped, brought public pressure and a greater level of associated shame. A similar strategy has to occur in the realm of social protection for the pathway of *C/D* → *F/G* → *CP* to occur in greater numbers.

The next step of the diagram (Figure 1) reflects the assessment of regulations by organizations on three different levels. First is the assessment of the enforcement of the policy. This was exemplified by F3 who choose to comply only in areas where the risk is high (e.g. Shanghai) (*pathway E* → *CP*) and by the perception that a 'hotline' increased the risk of detection (*pathway E* → *CP*). The second level is that of moral and ethical fortitude. In the case of F1 the organization saw compliance as a social obligation (*pathway F* → *CP*). The last level, public response/social action, ties into the second step. Several firms in our study complied in order to maintain a good public image. Rather than viewing it from a moral or ethical stance firms wish to maintain a strong public image to strengthen brand image or to increase market share and thus avoid financially costly public response (*pathway G* → *CP*). Once an organization has assessed the policy, the state's capacity, enforcement issues, ethical standards and possible public response it then needs to weight the potential benefits. It is important to note here that the possible gain may not be just financial (e.g. it may be power).

A final note is that the entire process is contextual. Political, economic, and societal forces may influence any one of the steps in the process. A strong economy with few competitors may reduce the need for non-compliance. A change in government may create a more favorable climate for non-compliance. A shift in societal values may induce compliance (e.g. a shift in attitude towards pollution in China). In our sample F3 provides an excellent example of weighing all the factors. F3 was compliant in Shanghai because they believed the risk outweighed the reward; whereas, in other areas of China they were non-compliant because the reward outweighed the risk (*pathway [H]* → *B* → *E* → *NCP*).

While employees, firms and governments may agree that they have a collective interest in sustaining fair and efficient social protection regimes; individual firms can gain a competitive advantage by not complying with mandated social protection regulations. Although employers' perceptions and responses to social policies vary, a common view is that so long as the regulations remain a 'paper-tiger' without formally legislated and rigorously enforced requirements, free-riding or non-compliant behavior will remain rampant. To create a social protection regime that is a vital part of China's institutional framework policy makers and regulators must understand

all the pathways that lead to compliance and utilize strategies that encourage travel along the correct path.

NOTES

- ¹ For the purpose of clarity we define government regulation as 'deliberate state influence' through a 'specific set of commands' enacted to protect or promote the well-being of the general public (public interest) (Baldwin and Cave, 1999, p. 2). This definition is drawn from Baldwin and Cave, 1999 and Dibadj, 2006.
- ² [] indicates a moderating relationship.
- ³ / indicates that it may affect any number or combination of the variables.
- ⁴ {} indicates that it affects both variables.

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Table 1: Profile of Case Firms in Shanghai in 2002

Case firm	F1	F2	F3	F4	F5	F6	F7	F8
Industry	<i>Manufacturing</i>	<i>Manufacturing & Trading</i>	<i>Investment Holding</i>	<i>Real Estate</i>	<i>Cable Manufacturing</i>	<i>Manufacturing</i>	<i>Pharmaceutical</i>	<i>Equipment Manufacturing</i>
Nature of the business	Knowledge-based and capital intensive	Knowledge-based and highly skilled	Diversified from highly to low skilled industries	Highly skilled and lucrative	Semi-skilled and labor intensive	Semi-skilled and labor intensive	Knowledge-based and highly skilled	Semi-skilled and labor intensive
Ownership type	WFOE* (Sweden)	WFOE (USA)	POE	SHE-A**	POE	POE (SHE-A)	SHE-A	SOE (SHE-A)
Size (no. of employees)	45	600	15,000	230	985	1748	200	2,400
Age of the firm (years)	3.5	9	17	10	25	29	3	43/10
Staff Level of Interviewee***	HRM	HRM & HRS	DGM & SM	GM	HRM	DGM, HRM & HRS	HRM & DHRM	GM, HRM, HRS & UR
Sales revenue per head (in RMB)	1,804,348	2,166,667	1,200,000	20,000,000	710,660	292,184	750,000	251,700
Average annual salary of the firm in 2002 (in RMB)	84,000	96,000	15,000 (workers) 100,000 (at HQs)	135,000	20,000	18,000	58,500	19,500
Insurance package (five basic insurances) offered to local urban employees	YES	YES	YES	YES	YES	YES	YES	YES
The same insurance package offered to migrant workers	N/A****	N/A	NO	N/A	YES various	NO	N/A	NO
Additional insurance coverage paid by the firm to local urban employees	Commercial medical	Commercial selective	Commercial selective	Commercial medical	Commercial selective	YES	NO	NO
Additional insurance coverage paid by the firm to migrant workers	N/A	N/A	NO	N/A	Commercial selective	NO	NO	NO
Year that the firm was audited and results (+ overpaid, - underpaid)	N/A	N/A	N/A	N/A	N/A	2003 (-)	2002 (-)	1999 (-) 2003 (-)
Had trade unions and joined SWMA*****	NO	YES	YES	YES	YES (late 2001)	YES (SWMA)	YES	YES (SWMA)

Note - Average annual salary in Shanghai – 19,476RMB

*WFOE – refers to wholly foreign owned enterprise **SHE-A – Shareholding firm listed in the Shanghai stock market, can only issue shares A.

***Staff Level of Interviewee – HRM – Human Resource Manager; HRS - Human Resource Staff Member; DGM – Deputy General Manager; SM – Senior Manager; GM – General Manager; DHRM – Deputy Human Resource Manager; and UR – Union Representative.

****N/A = not available*****SWMA – refers to Shanghai Workers' Mutual Association, which belongs to the All China Federation of Trade Unions Shanghai Branch.

Figure 1: Model of Regulatory Compliance

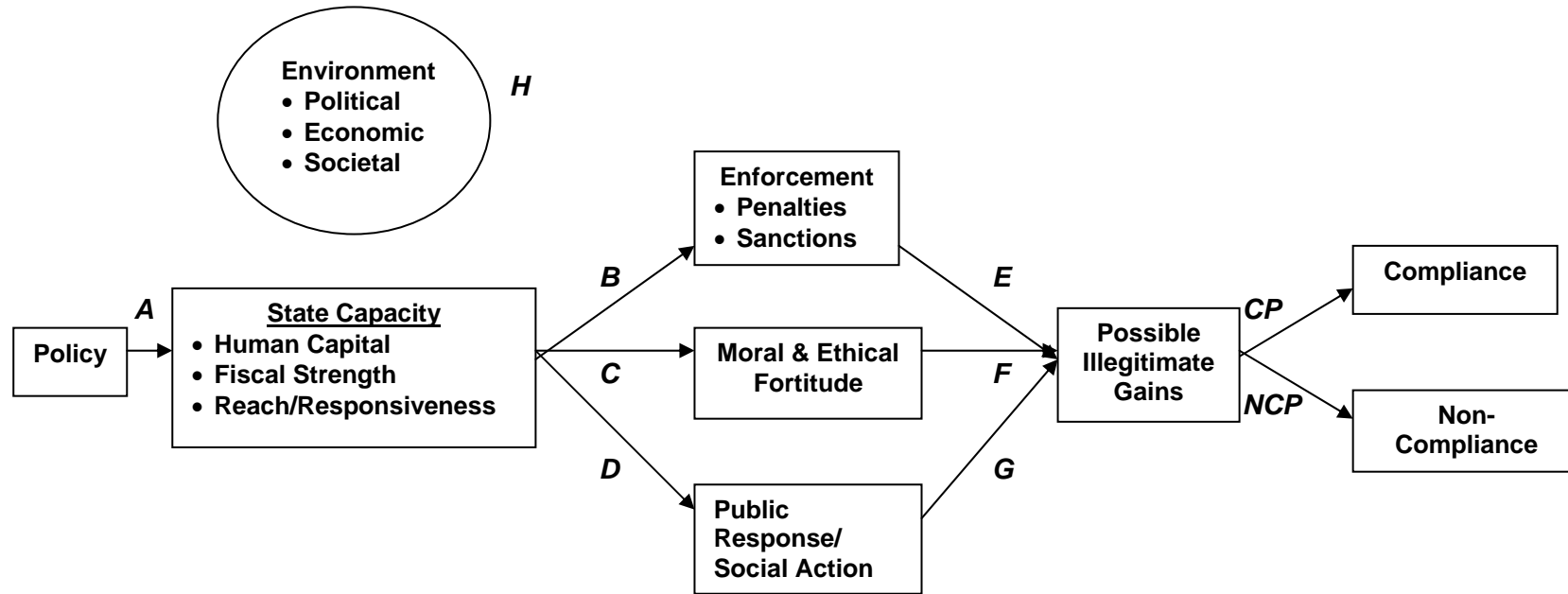
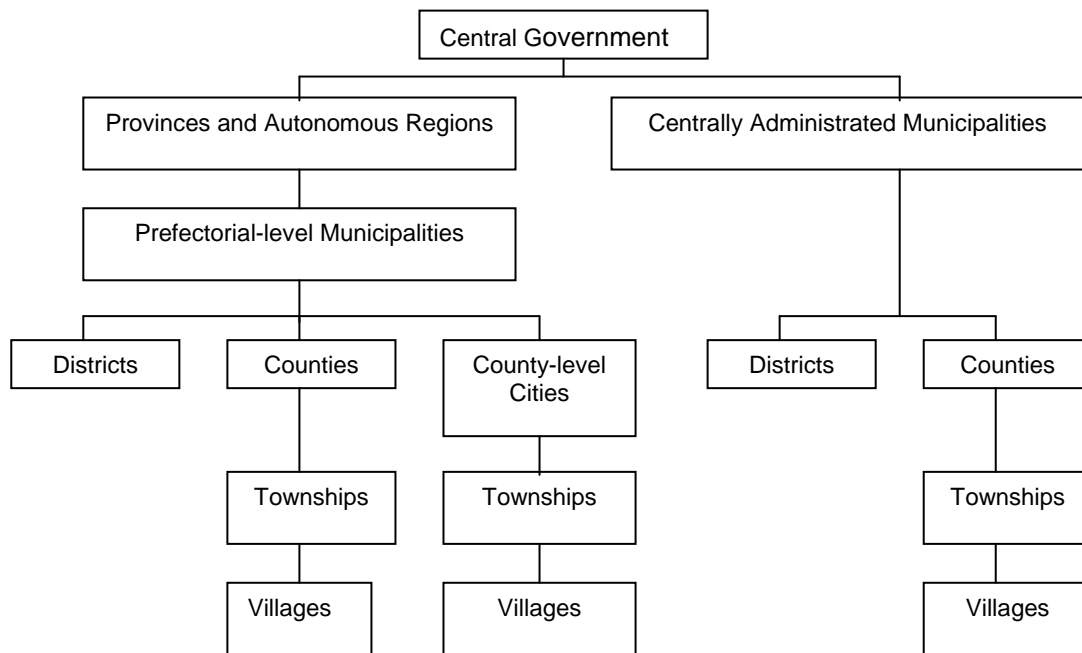


Figure 2: Government Layers in China



Adapted from *“Environmental regulation in China”* by X. Ma and L. Ortolano, 2000, p. 34.