Management and Organization Review 4:2 211–223
doi: 10.1111/j.1740-8784.2008.00110.x

Collective Goods, Free Riding and Country Brands: The Chinese Experience

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ABSTRACT Company brands signify a message to consumers about the quality and value of a product. Countries can also be branded. However, unlike the brands of individual firms, country brands are collective goods. The nature of country brands creates the possibility of free riding, where individual firms benefit – in terms of price or access – from the promise made by a country brand but deliver at a level lower than what is promised by the brand. Such free riding threatens the stability of what the country brand represents unless legal, governmental, or other institutions engage in activities to reduce these adverse effects. In this paper, we investigate the Chinese brand – once standing for average quality at a low price – in the light of recent recalls. We examine how country brands emerge and the incentives that firms operating in a country have to either support or not support a country brand. We also explore the implications of these incentives for the role of various institutions, including the government, in developing, maintaining and changing a country brand and in developing and enforcing the policies, such as protection of intellectual property, necessary to support firms' efforts toward reinforcing a trusted country brand.

KEYWORDS China, country brand, firm strategy, free riding

INTRODUCTION

A brand is a promise that is made to customers about the quality and value of the products or services they purchase (Kotler, 2003). Different brands make different promises. Some brands promise 'value' – moderate quality and performance at relatively low prices; other brands promise 'quality' – high levels of performance at relatively high prices and so forth. It is even possible for a brand to promise low quality and low performance along with low prices (Dodds, Monroe, & Grewal, 1991).

Traditionally, the concept of a brand has been associated with firms pursuing strategies in product markets (Dickson & Ginter, 1987). However, countries can also be branded. Each of the statements 'Made in the USA', 'Made in Korea', 'Made in

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Japan' and 'Made in China' promise something to consumers about the products and services manufactured in these different countries. Those promises apply broadly to all the products (and services) produced by firms located in a country and can be thought of as country brands (Supphellen & Nygaardsvic, 2002).

Until recently, research on consumer perceptions suggested that the country brand 'Made in China' stood for low cost and good value (Interbrand, 2007). This country brand emerged out of the business level strategies pursued by many Chinese firms, namely, a strategy that focused on average quality linked with very low cost manufacturing (Loo & Davies, 2006). The success of these strategies has led China to develop the reputation – the brand – as the 'world's factory' (Deloitte Research, 2003).

However, over the last several years, the Chinese brand for low cost and good value has begun to shift (Haft, 2007). Reports of toys painted with lead paint (Casey, 2007), toothpaste with toxic ingredients (Bogdanich, 2007) and dangerous pharmaceutical drugs (Zamiska & Johnson, 2008) have begun to create the perception that products manufactured in China are both low cost and low quality. As reported by Beamish and Bapuji (2008), by the second half of 2007, almost 80 percent of the people in the USA reported that they were apprehensive about buying products made in China – a significant change from the belief held, just a short time earlier, that Chinese manufactured products represent good quality at low cost.

This paper uses the Chinese experience to examine both the emergence of and changes to country brands. In particular, it is suggested that a country brand can be thought of as a collective good and that when the interests of individual companies are no longer consistent with the promise implied by a country brand these firms may begin to engage in activities that have an adverse impact on that brand – an example of free riding. This same conceptual apparatus is then used to suggest actions that might be taken to restore the value of a country brand.

THE EMERGENCE OF COUNTRY BRANDS

In general, country brands emerge out of the strategies that firms in a country pursue (Jaffe & Nebenzahl, 2001). If leading firms in a country consistently use state of the art technology in implementing their product market strategies, over time that country may develop a brand reputation as a source of high technology products. If leading firms in a country consistently emphasize the quality of design in their product market strategies, over time that country might develop a brand reputation as a source of products with advanced design characteristics.

Of course, this does not suggest that there are no actions that governments can take to try to brand their country in particular ways. Indeed, countries often advertise in international media, focusing on the attributes of their country that they want to emphasize in developing their brand (Olins, 2002). As will be discussed

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later, governments can also take a variety of actions to facilitate the development of, maintenance of, or changes to a country's brand. However, to the extent that the strategies pursued by firms in a country are systematically inconsistent with the brand that a government is trying to create for a country, over time it will be difficult for the government to sustain that brand (Papadopoulos & Heslop, 2002).

In the case of China since the 1980s, most Chinese manufacturing firms involved in exporting products overseas have adopted a strategy of low cost leadership (Porter, 1980). This strategy exploits China's current advantage in low cost labour (Saran & Guo, 2005). This does not imply that there are no Chinese firms adopting global product differentiation strategies. However, most observers agree that the bulk of Chinese firms, and especially those that provide original equipment manufacturer (OEM) services to non-Chinese firms, are pursuing cost leadership strategies (Child & Rodrigues, 2005).

It seems likely that the widespread adoption of low cost leadership strategies by Chinese exporting firms has led to the general perception among international consumers that Chinese products are characterized by average quality and low costs (Interbrand, 2007). This 'Chinese brand' is applied by consumers generally to all products manufactured in China – including those whose quality, in reality, is inconsistent with this brand.

COLLECTIVE GOODS, COMPETITION AND COUNTRY BRANDS

Once a country brand is established, it has many of the attributes of a collective good. Collective goods are services or assets that, once created, are both non-rivalrous and non-excludable (Samuelson, 1954). Non-rivalrous means that one firm consuming this collective good does not significantly reduce the amount of this good that can be consumed by another firm in the short to medium term; non-excludable means that it is very costly to exclude individual firms from taking advantage of a good once it is in place. Taken together, these attributes of a collective good imply that individual firms can gain any benefits that might exist because of the existence of a collective good, even if they fail to engage in activities that contribute to or support that collective good (Olson, 1965). This is known as free riding.

Free Riding on Country Brands

Free riding on collective goods can take many forms. In the case of country brands, free riding can take the form of products or services that are inconsistent with the country brand. Firms can gain the benefits of a country brand – in the case of China, a reputation for average quality and low costs – and obtain contracts and revenues consistent with this brand while at the same time delivering

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low quality products to consumers. For a time, these firms will enjoy the revenue streams associated with average quality and the costs associated with below average quality.

Free riding on collective goods – such as country brands – is very common and is likely to emerge unless economic and social sanctions are in place to prevent its occurrence. Some of these sanctions will be discussed later in this paper. Free riding is particularly likely to occur when the incentives of individual actors – in this case firms – conflict with the interests of the collective – in this case in maintaining a country brand. Such free riding, in the long run, is likely to undermine the existence of a collective good (Doyle, 2001; Olson, 1965).

Competition and Free Riding

Such a conflict between individual and collective interests may exist in the case of China's recent 'quality crisis'. It may be the case that the short-term profit maximizing interests of at least some Chinese firms may be inconsistent with maintaining the good value of China's brand.

Earlier, it was suggested that most Chinese manufacturing firms are using the access to low cost labour to implement cost leadership strategies. However, since most Chinese firms have access to the same low cost factors of production – especially a common pool of low cost labour – a cost leadership strategy, even if it is consistent with the overall country brand, is not likely to be a source of competitive advantage for any single Chinese firm. That is, while low cost labour may be valuable – in that it reduces a firm's costs below what would be the case otherwise – among Chinese manufacturing firms, it is not rare and, thus, not a source of competitive advantage (Barney, 1991).

If Chinese manufacturing firms have nothing but low cost labour to offer their international trading partners and if low cost labour does not differentiate one Chinese manufacturing firm from another, it follows that competition among Chinese firms for the opportunity to manufacture goods for export will be intense (Barney, 1991). Indeed, prior research suggests that Chinese manufacturing firms in these settings typically appropriate only a small percentage of the total value created in the manufacture, distribution and sale of products (Nolan, 2001). Similar research shows that the average level of profitability of these firms is also quite small (Rosen, 2003).

When firm profits are highly constrained by an intensely competitive context and decisions to reduce quality below expectations are at least temporarily protected by the existence of a country brand that promises quality, it is not surprising that some profit maximizing firms may choose to increase their profits by reducing quality below the level promised by the brand. Any cost savings created by reducing quality below this level will translate directly into profits for a manufac-

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turing firm, at least in the short run. In the competitive setting that currently exists in China, the profit created by reducing quality may be the only profit available to a firm in a particular exchange (Luo, 2008).

Chinese firms could reduce quality below standards implied by a country brand either themselves or by subcontracting manufacturing to other Chinese firms (Lyles, Flynn, & Frohlich, 2008) and then not monitoring the quality of the products provided by these subcontractors (the *cheng bao* process). Whether done by a firm or by a subcontractor, the effect on the ultimate quality of the product manufactured is the same.

Alternatively, instead of producing substandard quality products, firms facing this intense competition may agree to manufacture products that do not meet international quality standards. This may have been the case with respect to toys manufactured in China and distributed globally. Current work suggests that most of the recent toy recalls were due to design choices made by the international partners of Chinese firms (Beamish & Bapuji, 2008). However, Chinese firms were apparently willing to manufacture these toys, even when their design features did not meet international safety standards.

None of this means that some of the quality issues recently identified among Chinese companies might not simply reflect manufacturing errors on the part of these firms. Such manufacturing mistakes can take place in any competitive setting and may not always be the result of decisions made by managers (Hegde, Kekre, Rajiv, & Tadikamalla, 2005). In contrast, the competitive setting that exists in China is at least not inconsistent with the notion that some Chinese firms would consciously and deliberately chose to increase their profits by reducing their quality below the level promised by the Chinese country brand. Luo (2008) attributes this behaviour to degraded morals among Chinese manufacturers and loose organizational control. We suggest that such free riding behaviour can occur for even the most moral people.

Free riding on country brands may ultimately put the value of those brands at risk (Doyle, 2001). This negative consequence of undermining the country brand may, in the long run, hurt the performance of all Chinese firms by destroying the value of the Chinese brand.

MAINTAINING A COUNTRY BRAND

In the face of intensely competitive markets for products and services and strong incentives for free riding on an established country brand, from a policy standpoint, a logical question to ask is what actions, either at the governmental or industry level, can curb the free riding behaviour of individual firms? Economists have identified a variety of settings under which independent actors may play a role in stopping the free riding that can undermine a country's brand (Samuelson & Nordhaus, 2001).

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Government Monitoring

One condition for curbing free riding is the presence of extreme sanctions for such actions. For example, if a firm engages in activities that clearly undermine a country's brand, managers in this firm could be sentenced to jail or receive some other significant punishment that would have the effect of creating strong individual disincentives for engaging in such behaviour. Similarly, firms might be punished by heavy fines. In general, the economic value of these fines, including the probability that they will be both leveled and collected, would have to be greater than the present value of the cash flows generated by free riding on a country brand in order to act as a disincentive for firms to engage in free riding. Both the severity of these punishments and the probability of their occurring are important if they are to dissuade free riding behaviour (Arvey & Ivancevich, 1980). Even extreme punishments – including long prison sentences or the death penalty for selling substandard products – will not dissuade free riders if the probability of receiving such a punishment is extremely low.

Of course, monitoring firm activities in sufficient detail to evaluate the existence of free riding is costly, especially as the number of firms engaging in global manufacturing operations significantly increases. Onsite inspections, for example, take time, are expensive and are often not reliable.[1] Waiting until particularly egregious free riding has already occurred and is discovered by partners or consumers avoids these monitoring costs but puts the country brand – and perhaps the health and safety of consumers – at risk. The discovery, by consumers, that lead paint has been used on certain toys can enable the government to punish those who have put the country brand at risk, but only after that country brand has already been brought into question.

Mutual Monitoring

In addition to government monitoring, firms that have the most to gain from maintaining the quality of a country's brand may have private incentives to monitor other firms, to insure that these other firms do not engage in free riding that hurts the country brand. This mutual monitoring (Alchian & Demsetz, 1972) is most likely to occur when large and powerful firms gain competitive advantages associated with a country's brand, competitive advantages they seek to continue by maintaining that brand. When these private incentives are large enough, these firms will find it in their self-interest to monitor the actions of other firms. However, most Chinese firms are small (Meyer, 2008) and most firms are not in the position, due to lack of power or legitimacy, to influence other firms.

This incentive to monitor each other is one reason that firms often form trade associations (Kirby, 1988). In this sense, trade associations provide a setting within which firms can gain private benefits from assuring that the advantages associated

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with a collective good are not lost to free riding. These associations can facilitate not only the mutual monitoring process – through a regional or national information sharing system, for example (Luo, 2008) – but may also be instrumental in the creation of social norms that mitigate against free riding (Ostrom, 2000). However, in China, trade associations are generally run by the government, making it more difficult for firms to engage in this mutual monitoring and less likely for social norms that control free riding behaviour to emerge.

CHANGING A COUNTRY BRAND

While government monitoring and mutual monitoring can sometimes prevent free riding on a country brand, it will often be the case that such free riding will nevertheless occur – especially when intense competitive pressures lead firms to sacrifice long-term performance for short-term gains by producing products that are inconsistent with the country brand. Through this process, a new country brand may be created. In the case of China, this new country brand may promise 'poor' or even 'dangerous' quality along with low costs. It seems likely that this brand holds limited economic value for Chinese manufacturing firms. In this setting, what, if anything, can be done to change a country's brand? The recent experience of two countries – Japan and Korea – is instructive in this context.

The Experience of Japan and Korea

After the Second World War, the brand 'Made in Japan' stood for low cost, low quality products. In general, Japanese firms entered international and especially US markets with low quality, low priced products (Christensen, 1997). Indeed, the cost and quality of these products was so low that in some markets, domestic firms gladly ceded these segments to Japanese firms so that the domestic firms could concentrate on high quality, higher margin segments (Christensen, 1997).

Over time, as the cost of labour in Japan increased, it became clear that it would be difficult for Japanese firms to focus their efforts exclusively on the low end and remain profitable. By the 1980s, many Japanese firms were in the process of shifting from a position of low cost and low performance to a position of high quality and performance. In industry after industry, Japanese firms went from producing among the worst, least sophisticated products to producing among the best, most sophisticated products. This process has been thoroughly documented in several industries, including the worldwide motorcycle, automobile and consumer electronics industries (Matsui, 2002; Yamamura, Sonobe, & Otsuka, 2005), to name just a few.

Over time, as more Japanese firms manufactured highly differentiated high quality products, the brand 'Made in Japan' began to shift as well. Where once it

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promised low quality and low prices, by the early 1990s, it promised high quality, sophistication and technical superiority, at least in some markets.

Government actions played some role in helping create this new 'Made in Japan' brand. The role, for example, of the Japanese Ministry of International Trade and Industry (MITI) in facilitating certain technological investments in certain Japanese industries has been well documented (Johnson, 1982; Ouchi, 1984).[2] More importantly, the government was essential in creating and maintaining a system of private property rights, including the protection of intellectual property, which made it in the self-interest of firms to pursue highly differentiated product market strategies (Demsetz, 1967).

Building on these government actions, individual firms developed the resources and capabilities needed to produce high quality and sophisticated products for world markets. These actions ultimately led to change of the Japanese country brand. Put differently, when enough Japanese firms found it in their self-interest to begin manufacturing high quality, high performance products, the brand 'Made in Japan' began to evolve.

The brand 'Made in Korea' seems to be undergoing a similar transition. In the automobile industry, for example, initial investments by Korean firms in international markets focused on low cost, low performance, low quality automobiles. Following the pattern established by Japanese firms and identified in a variety of industries by Christensen (1997), some Korean firms have begun selling higher quality, higher performance automobiles in international markets (Kim, 2006). A similar pattern seems to be emerging in the Korean consumer electronics and white goods industries (Kim & Lee, 2002). The brand 'Made in Korea' may be evolving to stand for high quality and performance (Kim, 2006).

Is it possible that the brand 'Made in China' will someday evolve in similar ways to represent high quality and good value? While important cultural differences exist between Japan, Korea and China, if the 'Made in China' country brand is to evolve, it is likely to follow the pattern we have already seen in Japan and see now in Korea. Namely, to the extent that individual firms find it in their self-interest to develop the resources and capabilities necessary to shift their strategies from 'low cost' to 'product differentiation' in global markets and thus to begin building and selling high quality, sophisticated products, it may be possible for the brand 'Made in China' to change its implied promise. This has already begun in several industries, with several firms.[3]

Individual firms that change their strategies in ways consistent with their economic interests may have the effect, collectively, of changing the promise associated with the 'Made in China' brand. Further, because these individual firms gain private benefits from these actions – namely, the ability to avoid the intensely competitive markets for firms competing solely on the basis of undifferentiated low cost labour – there is less likelihood of free riding problems associated with these actions. Of course, once a new 'Made in China' brand is created, then many of the

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free riding problems described earlier may re-emerge, unless institutional infrastructure is developed to protect private property and to maintain a high probability of sanction when infractions occur.

Incentives for Firms to Change Their Strategies

On one level, it seems obvious why at least some Chinese manufacturing firms would find it in their self-interest to abandon their current low cost strategies in favour of highly differentiated strategies. Those low cost strategies are not proving to be very profitable for very many Chinese manufacturing firms (Brouthers & Xu, 2002). However, while the opportunity to pursue a more differentiated strategy seems obvious, its execution has significant associated challenges.

First, changing strategies from being a low cost producer to a highly differentiated producer requires firms to develop entirely new skill sets along with new organizational control and management systems. Inherent contradictions and conflicts between the capabilities needed to be successful at low cost production and those needed to be successful at product differentiation are well documented in the strategic management literature (Barney, 2008; Porter, 1980) and are likely to exist in China just as they exist in other countries. Changing strategies may put firms at a competitive disadvantage because the resources required to successfully implement a differentiation strategy are most likely to be deficient at the early stage. Whether or not a firm can overcome this resource deficiency, either through gradual internal development or leverage from external sources, is of critical importance to ensure the smooth transition as well as firm survival.

Brouthers and Xu (2002) also found that 'regional stereotypes' create challenges for firms as they seek to change their strategies. The worldwide perception that Chinese firms can only compete as low cost leaders makes it difficult for Chinese firms to change their strategies. In this sense, the Chinese brand not only creates advantages for firms that they can exploit by reducing quality below an acceptable level, it also creates barriers for firms, as they have to overcome these stereotypes before they can successfully implement new strategies.

That said, there are examples of companies that have made these shifts in the world economy. Volkswagen, for example, went from producing a low quality, low performance automobile 'for the people' to now producing high quality, high performance automobiles for the middle and upper market segments (Pfaffmann & Stephan, 2001). Other examples of firms that have made this kind of transition include Honda in automobiles, Sony in consumer electronics and LG in appliances (Hart & Christensen, 2002; Ihlwan, Edwards, & Crockett, 2005). Not surprisingly, underlying any of the above strategic transitions is the reconfiguration of firm level resources (Barney, 1986) and the existence of strong institutional protection of intellectual property of the firms. Studying how these firms made this transition can be instructive to Chinese firms seeking to duplicate this activity.

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However, there are broader issues within the Chinese context that seem to make this transition somewhat more difficult. Among these is the weak enforcement of intellectual property rights in China. Firms producing highly differentiated and sophisticated branded products must generate a price premium in order to justify the extra cost of design, production and distribution (Porter, 1980). These price premiums are hard to maintain when product brands are broadly counterfeited and when underlying technologies are copied. Put another way, it seems unlikely that pursuing a highly differentiated product market strategy will be attractive to many Chinese firms – despite the benefit that these strategies would have for the Chinese brand – until intellectual property rights are more systematically enforced in China. It may be coincidence, but it is also the case that the 'Made in Japan' and 'Made in Korea' brands both began to evolve when intellectual property rights in these two countries began to be more systematically enforced (Helpman, 1993; Tatsuno, 1990).

Of course, the systematic enforcement of property rights is yet another example of a collective good. While a variety of mechanisms for investing in such collective goods have been suggested in the literature (Samuelson & Nordhaus, 2001), in the end, most scholars agree that government often plays a role in the creation of collective goods (Mahmood & Rufin, 2005). In this sense, the national Chinese government has a significant role in the systematic protection of intellectual property rights to facilitate the change in strategies by Chinese firms in ways that, ultimately, realize the promise implied by the brand 'Made in China'. This means that, in the long run, what the brand 'Made in China' comes to stand for will depend, to a great extent, on the interaction between the strategies of Chinese firms and the policies of the Chinese government.

CONCLUSION

Can the brand 'Made in China' be trusted? For some time now the answer to that question – as reflected in consumers' beliefs about Chinese products – has been yes, but this affirmation of trust is dwindling. The Chinese brand has stood for low costs and good value. However, intense competition among Chinese manufacturing firms has led some of these firms to 'free ride' on this brand, manufacturing substandard products that threaten to undermine this brand to the detriment of all Chinese manufacturing firms. We suggest several solutions to curb the free riding problem. Government actions and mutual monitoring can impose direct costs of free riding on the free riders. Another solution is to alter firm strategies from those of low cost providers to firms that seek product differentiation. This transition would be facilitated by the systematic enforcement of intellectual property rights. To the extent that the Chinese government and Chinese firms concurrently pursue these alternative actions, they may begin to have a positive impact on the Chinese brand. In the long run, 'Made in China' may come to mean more than low prices and good value.

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NOTES

[1] Recent examples of the limitations of onsite inspections in the US meat processing industry suggest that the limitations of this monitoring device are clearly not restricted to China (Kim, 2008).

[2] Recall, however, that MITI tried to prevent Honda from entering the worldwide automobile market and that the first 256K RAM device developed in Japan was a Japanese electronics firm that was not included in a MITI sponsored research consortium. See Ouchi (1984) for details. Also, other aspects of government policy, especially an unwillingness to force large Japanese banks to write off bad loans has been widely cited as a major reason for a decade long recession in the Japanese economy. See Hoshi and Patrick (2000) for details.

[3] China International Marine Containers Group (CIMC), for example, has been moving from a low end, volume producer toward global leadership by emphasizing technical sophistication. Other examples of firms pursuing such differentiation strategies include Vimicro – a leading fabless semiconductor company, ZTE – a leading global provider of telecommunications equipment and network solutions, and Gree – a home electric appliance company, among others.

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https://doi.org/10.1111/j.1740-8784.2008.00110.x Published online by Cambridge University Press

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Manuscript received: March 4, 2008
Final version accepted: April 21, 2008
Accepted by: Marshall W. Meyer

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https://doi.org/10.1111/j.1740-8784.2008.00110.x Published online by Cambridge University Press