

# The impact of Guanxi on Chinese managers' transactional decisions: A study of Taiwanese SMEs

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**Abstract.** Guanxi is an important source of competitive advantage; managers in Chinese enterprises have especially placed enormous emphasis on it. The purpose of this study is to investigate the relationship between managers' initiative toward a Guanxi formation and their transactional decisions within the network. Findings of this study suggest that managers' initiative in setting up a Guanxi network has important impact on their perceptions toward members in the network; and in turn, the perception has an impact on their transactional decisions within the Guanxi network. More specifically, managers would employ relational mark-down and compensatory mark-up to differentiate Guanxi members from non-Guanxi members in making transactional decisions.

**Keywords:** Guanxi, relational mark-down, compensatory mark-up, transactional decisions



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## 1. Introduction

Guanxi is an ancient system based on personal relationships and has dominated business activities throughout the history of China and East Asia [16]. It implies an informal network established through the exchange of favors among members; its mechanism is to facilitate economic activities among individuals or organizations. In Chinese enterprises, the cooperative networks of managers incorporate a Chinese type of relationship (Guanxi), which integrates specific emotions and mutual benefits into one mode. During the integration process, weights are assigned to the non-computable emotion and the computable benefits; the result is that Guanxi becomes a weighted relationship between emotions and benefits [5].

The entrepreneurial relationship is often referred to as "Guanxi" in Chinese terms. Often times, Guanxi is originated from personal relationships to which an enormous amount of effort is or will be committed. However, almost all of the management studies investigated the issue of Guanxi either at the departmental (group) level or the institutional (organization) level (for example, [23,24]). Not too many studies explored

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individuals' perceptions toward a Guanxi system and its impact on managers' transactional behaviors. Thus, the paper tries to fill up this research gap.

## 2. Theory and hypotheses

### 2.1. Building and developing Guanxi

Davies [6] defined Guanxi as the social interactions within a network whose members reciprocally engage in the infinitely repeated games that include the exchange of favors, the evaluation of trusts, and the share of benefits. These games are performed to minimize the risk of uncertainty and inflexibility of some specific assets [23]. Historically, Chinese have been lived in a hierarchical society in which major resources are controlled and allocated by some elites [21]; aggressively setting up a Guanxi network with those elites would therefore gain easy access to resources.

Taking into account the acquisition of resources, the potential to make business transactions efficient becomes another constructive mechanism of Guanxi networks. Granovetter [9] observed that separating one's economic activities from the ongoing social networks is a difficult, if not impossible, task. In other words, a social market structure could be developed in addition to the economic market structure whenever business activities are in progress. When the social market structure matured, it functions as a Guanxi network where members of the network begin to build mutual relationships as well as to share and exchange organizational information. Individuals could use these information and resources to achieve future economic goals. That is how Chinese family businesses overcome size limitations in a competitive environment [20]. More specifically, Chinese enterprises usually create and maintain a competitive advantage through aggressively initiating a Guanxi network.

How a Guanxi network functions can be observed from the fact that a dichotomy, insiders versus outsiders, is formed when a Guanxi network is developed. Being an insider, an individual or organization would enjoy some privileges within the Guanxi network and obtain particular benefits in performing business activities [14,15]. Wong and Chan [23] indicated that insiders would provide the same kind of trust that could only be found in a network of family ties and that the trust would become instrumental within business circles, especially under an inequitable legal system. So the insiders/outside concept might distinguish highly

effective Guanxi networks from those that are less effective.

Guanxi is like a marriage; both parties have to be willing to form the relationship. Individuals' willingness toward the establishment of a Guanxi network would therefore be a critical factor in predicting the network's effectiveness and persistence. Thus, self-initiation could be a key notion to the study of Guanxi networks. Putting together the concept of insiders/outside and self-initiation, the following hypothesis is developed.

**Hypothesis 1.** Individuals are more willing to perceive members of a Guanxi network as insiders if the Guanxi network is developed on their own initiatives.

### 2.2. Social capital and managers' transactional decisions

Since Guanxi could help managers make efficient business transactions, it would be interesting to see how managers make transactional decisions within a Guanxi network. Lui [17] suggested that transactional decisions made by managers of small and medium enterprises (SMEs) in Taiwan were usually based on two factors, potential values of social transaction (PVST), an invisible asset that is expected to be valuable for organizations both now and in the future, and potential values of economic transaction (PVET), a physical asset or economic benefit to be earned immediately from a transaction. Since social capital, interpreting in economic terms, can reduce transaction cost [13], managers may be willing to give up some economic benefits, or the PVET, contained in a transaction when the PVST is available. By doing so, managers could improve mutual relationships and take advantage of the relationship in the future [11]. To be more illustrative, the concepts of relational mark down (RMD) and compensatory mark up (CMU) could provide materialized explanation regarding managers' transactional behaviors toward a Guanxi network [25]. The RMD refers to the loss of economic benefits due to managers' intentions to obtain and maintain a social relationship with other organizations. In other words, managers are willing to give up some PVET in exchange for some PVST. The loss of the economic benefits would hopefully cultivate mutual trust and transfer it into a long-term Guanxi network that is valuable to managers or organizations in the future.

As for the CMU, it is acquired in most of the risky business transactions. For example, when managers

do not trust each other, anxiety exists due to the fact that the agreed-upon partnership will probably be disrupted or even not to be performed; managers may therefore ask for extra economic benefits, or an acceptable breach premium, to cover the risk of a possible loss [3]. The acceptable breach premium is one example of the definition of CMU. In order to balance the overall transactional costs and gains, managers would probably try to recover the loss of RMD, given to organizations that could bring PVST into a transaction, from organizations that could not bring any PVST into a transaction.

When Guanxi initiators make transactions with the intended Guanxi members, it is reasonable to expect that the intended Guanxi members would always bring some PVST into the transactions. Thus, Guanxi initiators would be willing to offer the RMD and not to ask for the CMU. That is because Guanxi initiators would always like to establish long-term positive interactions that could create an inter-dependence atmosphere [26] and trust [1] with intended Guanxi members. The atmosphere makes everyone in the Guanxi network become insiders in the future so that the interactions among Guanxi members would develop social capital. In fact, Hazleton and Kennan [11] suggested that the development of social capital is dependent on the stability and continuity of social structures. After the development of social capital is predictable, whenever Guanxi members engage in transactional activities within the network the transactions would probably bring some PVST in the exchange process. It would then influence the transactional decisions made by members within the Guanxi network. More specifically, when individuals in a Guanxi network are perceived as insiders, due to the development of social capital within the network, managers would offer the RMD and not ask for the CMU in making transactional decisions toward members in the Guanxi network. Thus,

**Hypothesis 2.** Individuals are more willing to offer the RMD or less willing to ask for the CMU in making transactional decisions within the network if the Guanxi network is developed on their own initiatives.

**Hypothesis 3.** The higher the extent to which an individual perceives members in a Guanxi network as insiders, the higher the extent to which an individual would offer the RMD or the less the extent to which an

individual would ask for the CMU in making transactional decisions within the network.

**Hypothesis 4.** Perceiving members in a Guanxi network as insiders will mediate the relationship between the initiative in setting up a Guanxi network and the transactional decisions on RMD/CMU within the network.

### 3. Method

A lab experiment was employed in this study. Participants were asked to make responses to fictitious scenarios that depicted a manager's willingness to set up a Guanxi network. Two scenarios (Appendix 1), manipulated with high and low initiative in setting up a Guanxi network, were included in this study. Each participant received only one scenario so that comparisons could be made between the two scenarios. Wording of the scenarios were refined after a pre-test, conducted with 120 business-majored college students. Subjects for this study were managers of Taiwanese SMEs who attended an MBA program for training purposes. After the manipulation check, a total of 157 questionnaires were valid. Fifty-four percent of the respondents were male, the average age was 38; fifty-two percent of those respondents were middle and top managers.

The study included three dependent variables: the extent to which an individual would perceive members in a Guanxi network as insiders, the RMD, and the CMU. Based on previous studies [15,23,25], ten 7-point Likert scale items were developed to measure these variables, four items for managers' perception, three items for RMD, and three items for CMU, respectively. The scales, reliability score and construct validity are reported in the Appendix 2.

### 4. Analysis

Descriptive statistics for all the variables were shown in Table 1. A rudimentary analysis shows that high initiative is associated with insiders, indicating that the higher the extent to which a manager is acting on his/her own initiative in setting up the Guanxi network, the higher the extent to which a manager would perceive members in the Guanxi network as insiders. Furthermore, association between initiative and RMD indicates that the higher the extent to which a manager

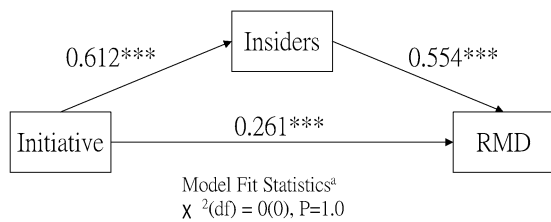
Table 1  
Descriptive Statistics<sup>a</sup>

Variable	Mean	S.D.	1	2	3
1. Initiative <sup>b</sup>	0.618	0.488			
2. Insiders	17.471	5.398	0.612***		
3. RMD	14.147	4.134	0.601***	0.714***	
4. CMU	10.522	3.751	-0.107	-0.291***	-0.329***

<sup>a</sup> N = 157.

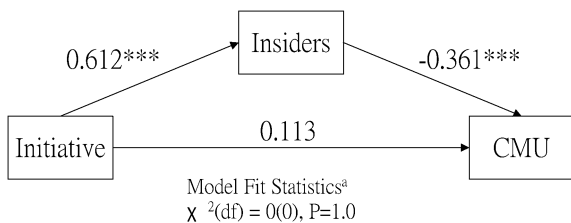
<sup>b</sup> 1 = high initiative, 0 = low initiative.

\*\*\* P < 0.001.



a. The model fit is best in using LISREL 8.30.  
\*\*\* P<0.001

Fig. 1. Path diagram for the variables of initiative, insiders, and RMD.



a. The model fit is best in using LISREL 8.30.  
\*\*\* P<0.001

Fig. 2. Path diagram for the variables of initiative, insiders, and CMU.

is acting on his/her own initiative in setting up the Guanxi network, the higher the extent to which a manager would offer relational mark down to members in the Guanxi network. Association between insiders and the two variables of RMD and CMU shows that insiders is positively related with RMD and negatively related with CMU.

Path analysis was employed to further investigate if insiders mediated the relationship between initiative and RMD, and between initiative and CMU. Figure 1 is the path diagram among the variables of initiative, insiders, and RMD. The direct effect from initiative to RMD is significant with a path coefficient of 0.261

( $P < 0.001$ ). The indirect effect from initiative to RMD is significant with the path coefficient of 0.339 ( $0.612 \times 0.554$ ) [7], which indicates that insiders appear to be a significant mediating variable for the relationship between initiative and RMD.

Figure 2 shows the path diagram for the variables of initiative, insiders, and CMU. Since the direct effect from initiative to CMU is insignificant (coefficient = 0.113,  $P > 0.05$ ), it does not indicate that initiative would have impact on CMU with itself. It appears that initiative would only have impact on CMU through insiders, and the impact is on the negative side.

Overall, Hypothesis 1 is supported, Hypothesis 2 is partially supported, Hypothesis 3 is supported, and Hypothesis 4 is partially supported in this study.

## 5. Discussion

### 5.1. Implications

Managers' initiative in setting up a Guanxi network would surely influence how they make transactional decisions within the network. There are always some managers who are more active than others in trying to set up a Guanxi network in order to take advantages of the relationships established inside the network. As a result, when managers are acting on their own initiatives in setting up a Guanxi network, they tend to perceive members in the Guanxi network as insiders and lose some degrees of impartiality in making decisions toward network members. In addition, managers would provide relational mark down and not ask for compensatory mark up from those who are perceived as insiders in a Guanxi network. These findings indicate that managers' initiative of setting up a Guanxi network, and the transactional behaviors thereof, are vital factors for the long-term survival of the relationships. The best condition of a Guanxi network is when (1) all Guanxi members are equally committed to the development of

the network, (2) the personal relationships established within the network are similar to those of old friends or favorable partners, and (3) the relationships derived from mutual understandings and frequent information exchanges are easily transformed into business relationships.

The concept of risk aversion could provide further explanation regarding the transactional behaviors of relational mark down and compensatory mark up. In general, most managers are looking at short-term organizational performances since it is one of the most convincing arguments to hold their jobs. Long-term return on investment is also an important issue, but not as immediately recognizable as short-term profits. Harrison and Fiet [10] indicated that managers have a tendency toward short-term results due to self-interest. To this respect, the compensatory mark up can be used as a tool to make sure that transactions are performed as planned, or to minimize the loss when transactions are disrupted by one way or the other. To some extent, compensatory mark up is a short-term consideration and managers would probably prefer not to give it away easily. Only when managers perceive members of a Guanxi network as insiders they would be willing to take the risk of forgoing short-term protection in hopes of enjoying long-term potential values from the network.

Results of this study mirror some previous findings regarding the characteristics of the Chinese business world. Guanxi involves a hidden and dynamic relationship, and the Chinese system of capitalism network works through the Guanxi network [2]. For Chinese, the Guanxi is an important source of competitive advantage [18,19,22], and thus managers have placed enormous efforts on setting up differentiated relationships. Significant ties, reciprocal mutual benefits, harmonious team spirit, trust and commitment will all be developed for those being identified as insiders in a Guanxi network [23]. Managers belonging to the same Guanxi network will work together on a series of tasks and convert conflicts into mutual benefits, as they perceive one another as insiders.

## 5.2. *Conclusion and future research*

Yen [25] and Fan [8] proposed that Guanxi is such unique Chinese cultural values, prevailed in political and socio-economic systems, that it cannot be studied alone from economic or financial perspectives. Since Guanxi is believed to be a type of social capi-

tal, it would easily become something valuable during a course of negotiation. This paper employs the social capital perspective to present the impact of Guanxi on transactional decisions and analyze the decisional outcomes through RMD and CMU. When high PVST exists, decision makers would have to take into account some long-term factors, i.e., emotions, face, trust, and Guanxi continuation, to make transactional decisions, in which more RMD such as discounts, prompt delivery, credit granting are offered or less CMU such as security deposits and risk premiums are charged. On the contrary, decision makers would ask for more CMU or cut down RMD offerings when PVST does not sufficiently exist to be an important decisional factor. The discussion of PVST and PVET as well as RMD and CMU would help understand why Chinese are inclined to buy from relatives or friends, or complete a transaction through relatives or friends in order to obtain better deals. It clearly shows that people not only attend to business contract but also pay attention to contract of Guanxi in order to make transactional decisions in the Chinese business world [16]. Consequently, members in the networks of Chinese enterprises, especially in small and medium firms, frequently depend on Guanxi contract more than on business contract to carry out business activities. That is perhaps one of the reasons why family business is so prosperous in the Chinese business world [5,25].

Furthermore, the term "Guanxi" is far more complicated than the Western term "relationship". Fan [8] indicated that Guanxi is a live and dynamic connection, working like an electric circuit, which can be connected and switched on. For Chinese, Guanxi can be established from the scratch through self-endeavor (e.g., pull Guanxi). It can also be started out from blood relationship or particular ties and personal feelings. Under some circumstances Guanxi is transferable. Guanxi members, acting as the intermediary third party, can pass on the relationship to designated persons. On the other hand, Guanxi can be treated as a type of social investment [4]. Guanxi would normally become a personal or organizational asset, resource, or insurance policy. It would even create competitive advantage when it's necessary [8,19,22,24]. In essence, Guanxi is the mix of trade off between social (subjective emotion) and economical (objective reality) considerations [5,25]. Therefore, applying the concepts of PVST and PVET to discuss the impact of Guanxi on transactional behaviors of Chinese managers could provide some insights to the field of organizational behavior and the study of individual decision-making behaviors.

The major conclusions of this study suggest that managers' initiative in setting up a Guanxi network has important impacts on how they would perceive members of the network, and in turn, the perception has an impact on decision-making behaviors. The interpretations, however, are subject to some limitations. Participants of this study are selected from management training programs; generalizations therefore may probably be applicable only to those managers with high need for achievement. Furthermore, all subjects are Taiwanese managers. Cultural differences are surely an issue to be looked into. The other limitation is that fictitious scenarios are developed as the major research method for this study. It could always contaminate the results if the manipulation embedded in each scenario is not strong enough for the subjects. Future studies could do the analysis on some existent Guanxi networks and come up with in-depth knowledge on how managers perform transactional decisions within a Guanxi network.

## **Appendix 1. Two scenarios of the study**

### *A.1. High initiatives*

The owner of "XXX" dyeing and finishing factory was once the superintendent of a small dyeing and finishing factory in Northern Taiwan. Since he had worked on two dyeing and finishing factories and was born on a typical textile town, he has been very familiar with the industry and possessed a great deal of professional knowledge and technical know-how. Recently, under his family's encouragement and financial support, he decides to open up his own dyeing and finishing factory. However, other than the necessary start-up fund, technical know-how and some helping hands from his previous associates, he is really short

of the necessary inter-organizational networks to bring enough sales to the business. He therefore comes looking for you to be his business partner since you are his schoolmate and a long-time pal. Admiring his entrepreneurial spirit and wanting to start your second career opportunity, you join him from another dyeing and finishing factory and hold the position of business manager in "XXX". You know that being a newly founded small establishment in the dyeing and finishing industry, "XXX" has bumped into a lot of difficulties in setting up Guanxi networks with major buyers and sellers. Under these circumstances, you have noticed that one of the exporters of blue jeans fabric, "AAA" Factory, would offer a great deal of opportunities for "XXX". Thus, you are extremely interested in setting up a "Guanxi" with "AAA".

### *A.2. Low initiative*

"XXX" is a large and reputable dyeing and finishing factory in Northern Taiwan; it performs excellently in every respect. It also enjoys many loyal customers and good Guanxi networks in the industry. You are the executive manager of "XXX" and sometimes customers would have to solicit business from you. Recently, the owner of "XXX" came across a small exporter of blue jeans fabric, "AAA" factory, in a trade show. "AAA" told your boss that they want to do some business with "XXX". Your boss did not have time to entertain "AAA" so he handed the issue to you. You know that "XXX" is in perfect condition right now and do not need any business from "AAA". On top of that, you are busy in your daily work and would not be able to squeeze some time out to plan on the issue further. But just to carry out an order from your boss, you reluctantly decide to simply take some small orders from "AAA".

## Appendix 2

Table A2  
Measurement scales<sup>a</sup>

Variables	Items <sup>b</sup>	Reliability	Construct Validity <sup>c,d</sup>
The extent to which an individual would perceive members in a Guanxi network as insiders (Insiders)	<ol style="list-style-type: none"> <li>1. I would invite AAA's managers for family activities on holidays.</li> <li>2. I would help AAA's managers organize their daughter's wedding.</li> <li>3. I would invite AAA's managers to go abroad to participate trade shows.</li> <li>4. I would update the manufacturing equipment according to the AAA's suggestions.</li> </ol>	Cronbach's $\alpha = 0.85$	$X^2(df) = 1.06(2)$ $P = 0.60$ $X^2/(df) = 0.53$ CFI = 1.0 NNFI = 1.0 GFI = 0.99 RMSEA = 0 The model fit is quite good.
Relationship mark down (RMD)	<ol style="list-style-type: none"> <li>1. I would be willing to offer price discount to AAA.</li> <li>2. I would issue more guarantees for product quality to AAA than to others.</li> <li>3. I would put AAA in first priority when requested products are available.</li> </ol>	Cronbach's $\alpha = 0.84$	$X^2(df) = 0(0)$ $P = 1.0$ The model fit is best.
Compensatory mark up (CMU)	<ol style="list-style-type: none"> <li>1. I would not inflate prices on AAA.</li> <li>2. I would not ask for more deposit from AAA than from others.</li> <li>3. I would not request AAA to pay first before making a delivery.</li> </ol>	Cronbach's $\alpha = 0.76$	$X^2(df) = 0(0)$ $P = 1.0$ The model fit is best.

<sup>a</sup>The response options for the subjective items ranged from 1, "strongly disagree", to 7, "strongly agree".

<sup>b</sup>AAA is a virtual company for this experiment.

<sup>c</sup>Confirmatory factor analysis, using LISREL 8.30 [12], was employed to check the construct validity of measurement with the observed data ( $n = 157$ ).

<sup>d</sup>"GFI" is the comparative fit index; "NNFI" is the non-normed fit index; "GFI" is the goodness-of-fit index; "RMSEA" is the root-mean-square error of approximation.

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