

IDENTITY, COMMUNITY, AND AUDIENCE: HOW WHOLLY OWNED FOREIGN SUBSIDIARIES GAIN LEGITIMACY IN CHINA

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Conceptualizing different foreign entry modes as distinct organizational forms, we examine how wholly owned foreign subsidiaries (WOFs) gain legitimacy in a host country. Drawing on the institutional and ecological perspectives, we build a legitimation framework based on the ideas of identity, community, and audience. Specifically, we identify dual sources of legitimating influences for these subsidiaries in China in 1979–95: foreign direct investment (FDI) communities, and host country public opinion. Our findings reveal that the legitimation and competition dynamics of FDI communities and Chinese acceptance of the organizational form both influenced adoption of wholly owned foreign subsidiaries in China.

Choosing a mode for entering a foreign market has been one of the most intensively studied topics in international management (Caves, 1996; Guillén, 2003). The main theoretical approaches employed in this research include transaction cost theory (Anderson & Gatignon, 1986; Hennart, 1988), the corporate strategy perspective (Caves & Mehra, 1986; Contractor, 1990), and organizational learning and capability theory (Barkema & Vermeulen, 1998; Chang & Rosenzweig, 2001). Recently, scholars have begun to apply macro organization theories, such as institutional theory and organizational ecology, to the study of foreign entry mode choice (Guillén, 2002, 2003; Henisz & Delios, 2001; Lu, 2002; Yiu & Makino, 2002). These studies have contributed substantially to the understanding of factors leading multinational corporations (MNCs) to select one entry mode over others. However, previous research falls short in explaining the pro-

cess by which different entry modes acquire legitimacy and diffuse over time in a host market.¹

In this study, relating to but going beyond previous entry mode selection studies, we conceptualized foreign entry modes as distinct organizational forms and investigated how the wholly owned foreign subsidiary (WOFs) gains legitimacy as an organizational form over time in a host country. As Suchman stated, “Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (1995: 574). Whether an organizational form is legitimate is largely dictated by external audiences that assess its conformity to a set of social codes, and relevant interested actors can use collective action to foster such cognitive

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¹ The limitations of previous entry mode studies include (1) selecting only established foreign subsidiaries for study (e.g., Lu, 2002; Yiu & Makino, 2002), thus ignoring nonentries (Guillén, 2003), and (2) choosing only a subset of firms with certain characteristics, such as publicly listed companies (e.g., Guillén, 2003; Lu, 2002; Yiu & Makino, 2002), thus ignoring other potential adopters, such as private firms. Therefore, previous entry mode studies have been insufficient to examine the legitimation of particular entry modes because of sample selection bias, an issue widely recognized in the organizational literature (Carroll & Hannan, 2000; Denrell, 2003).

and sociopolitical legitimacy (Deephouse, 1996; Pólos, Hannan, & Carroll, 2002; Ruef, 2000; Ruef & Scott, 1998).

Guided by this idea, we treated the adoption of the WOFS form in a host country as a process of legitimation of an organizational form and identified two sources of legitimating influences: foreign direct investment (FDI) communities, and public opinion in the host country. Applying this framework, we first developed the concept of “FDI communities,” drawing on the institutional and ecological perspectives. Applying this concept, we investigated the strength of the legitimating influences of different FDI communities on the adoption of the WOFS form at a population level. We demonstrated the importance of higher-level legitimation and competition processes in shaping the legitimacy of the WOFS as an organizational form. For this purpose, we further defined FDI communities on the basis of home country of origin and industry type. This definition enabled us to test the proposition that a community with a higher degree of identity overlap (in which a firm is similar to other community members on both dimensions) exerts a stronger legitimating influence than other communities. Such an identity-dependent legitimation process provides a more refined theoretical foundation for investigating the adoption of the WOFS form and similar research questions.

We also investigated the effect of industry competition within the WOFS population on the legitimation process of the WOFS form. Cross-form spillover effects from the joint venture (JV) population on this process were investigated as well. This examination may offer new insights into the competition between these two forms of FDI, which are closely related in the “identity space.” Finally, we investigated the impact of public opinion in the host country, demonstrating the importance of local acceptance if wholly owned foreign subsidiaries are to acquire legitimacy and taken-for-granted routines of behavior in a host market.

In addition, we considered alternative drivers of the adoption of WOFS to acknowledge the international business literature on entry mode choice. For instance, we controlled for factors such as industry regulatory constraints, country risk, asset specificity, and accumulated FDI experience in our models in order to assess whether our theoretical variables added significantly to the effects that have been manifested in extant work. By directly controlling these economic, political, and regulatory factors in the context of an emerging economy, we attempted to isolate the institutional forces from these plausible and well-established mechanisms.

The empirical setting for the study encompassed

all wholly foreign-owned manufacturing subsidiaries set up in China from 1979 through 1995. China started an economic and institutional transition in late 1978, officially opening its doors to foreign direct investment. This research design thus allowed study of the adoption of the WOFS form from the beginning of China’s economic transition and its dynamics over time.

THEORETICAL BACKGROUND AND RESEARCH CONTEXT

Foreign Entry Modes as Distinct Organizational Forms

Organizational form refers to “those characteristics of an organization that identify it as a distinct entity and, at the same time, classify it as a member of a group of similar organizations” (Romanelli, 1991: 81–82). Recently, organizational ecologists have generally defined an organizational form as “a type of socially coded identity,” and this identity is further defined in terms of an established set of social codes that “specify the properties that an entity can legitimately possess” (Pólos et al., 2002: 85). According to this conceptualization, social codes possess rule-like status, and organizations conform to prevailing social codes by embracing legitimate organizational forms. This logic has been applied to explain the adoption of civil service reform (Tolbert & Zucker, 1983), multidivisional forms (Fligstein, 1985), matrix organization structures (Burns & Wholey, 1993), and partner-associate structures (Lee & Pennings, 2002).

In the current study, different foreign entry modes (specifically, the WOFS and the JV modes) were viewed as distinct organizational forms. Researchers have long noted that foreign firms need to gain legitimacy in a host country under conditions of uncertainty (e.g., Henisz & Delios, 2001). According to the institutional perspective (DiMaggio & Powell, 1983; McKendrick, Jaffee, Carroll, & Khessina, 2003; Meyer & Rowan, 1977), legitimacy signals taken-for-grantedness in an institutional environment and is necessary for organizations to obtain normal access to resources, protection from authorities, higher visibility, and enhanced life chances. In the context of foreign expansion, the WOFS and the JV may be subject to different social codes and correspondingly possess differentiated social identities (Yiu & Makino, 2002).

For instance, several studies have shown that joint ventures, established with a hybrid equity structure, are more susceptible to the effects of cultural distance than wholly owned subsidiaries, because the former have to contend with both na-

tional and corporate cultures, or “double-layered acculturation” (Barkema, Bell, & Pennings, 1996). This situation often creates ambiguities in a joint venture’s relationships with employees, a host government, and local players (Kogut & Singh, 1988; Shenkar & Zeira, 1987), which may differ significantly from the relationships confronting a wholly owned subsidiary. Meanwhile, research has also demonstrated that joint ventures are more likely to be favored by foreign firms investing in a new line of business, because of their need to seek local knowledge and complementary assets from partners (Gomes-Casseres, 1989; Harrigan, 1988).

The wholly owned foreign subsidiary and the joint venture can thus be considered distinct organizational forms featuring different equity structures (Gomes-Casseres, 1989), under different legal regulations (Contractor, 1990), following different employment practices (Shenkar & Zeira, 1987), and representing different product strategies (Harrigan, 1988). We set out to analyze the general pattern of foreign firms’ adoption of the WOFS form over time in China, taking into consideration the influence of the JV form on this process.

Two Sources of Legitimizing Influences

According to Kostova and Zaheer (1999), MNCs confront a multitude of different and possibly conflicting institutional forces. On the basis of their work, we argue that the legitimation of MNC subunits is subject to (1) “legitimacy spillover” from cognitively relevant communities of foreign investors and (2) the host country’s perception and acceptance of the subunits. Both institutional forces embrace important clues necessary for WOFS adoption. MNCs therefore have to observe, understand, and interpret correctly signals from these two institutional environments and their implications for the legitimation of different forms of subsidiary.

Legitimacy spillover in FDI communities. When evaluating the legitimacy of the WOFS form in an international context characterized by inherent complexity, MNCs tend to seek information and make sense of the situation by looking at other MNCs to which they are cognitively related in the surrounding environment. Drawing on organization theory research from a community ecology perspective, along with the institutional arguments (DiMaggio & Powell, 1983; Hannan & Freeman, 1989), one can define “FDI communities” as bounded sets of foreign-invested firms with related identities in a host country. The notion of an organizational community has recently been applied to define the boundaries of legitimation and com-

petition, and it can also be applied to examine the adoption and evolutionary dynamics of organizational forms within these boundaries (e.g. Ruef, 2000).

This study focused on the WOFS form in China and defined four generic FDI communities within this form based on national origin and industry type. Both outsiders and the firms themselves classify wholly owned foreign subsidiaries in terms of these two dimensions, and both of them have previously been applied for defining recognizable populations of organizations (Guillén, 2003; Yiu & Makino, 2002). We used those dimensions here to define spheres of organizational activity within which actors mutually recognize each others’ presence and actions (DiMaggio & Powell, 1983; Scott, 2001). The combination of these two dimensions generates a four-cell typology of the WOFS form in a particular host market: (1) same industry and home country (Community I), (2) same home country, different industries (Community II), (3) same industry, different home countries (Community III), and (4) different industries and home countries (Community IV). The focus in this study was on the rate at which wholly owned foreign subsidiaries entered Community I. This rate was taken as the dependent variable of this study. The entry rate of such subsidiaries into this community was proposed to be affected by legitimation and competition effects emanating from different FDI communities.

Acceptance in a host country. In addition to the influences stemming from FDI communities, host country cues may also be a source from which MNCs infer the legitimacy of the WOFS form. By Pólos et al.’s (2002) definition, a form is an external identity code, implying that it is the perceptions and acceptance of outsiders that matter. Once certain identity codes are established in the minds of relevant social actors such as customers, peer organizations, watchdog organizations, governments, and the general public, the codes are seen as a default to guide organizations about what is expected of them, and the corresponding identity circumscribes the organizations’ structures and procedures (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Ruef, 2000).

Social actors in a host country typically have sparse information with which to evaluate the legitimacy of MNCs and their subunits at an early stage. Therefore, they need to make sense of MNCs’ activities by gauging whether a particular entry mode that foreign investors have adopted is acceptable or appropriate. Meanwhile, MNCs are vulnerable to the liability of foreignness when launching cross-national businesses in a host country (e.g.,

Zaheer, 1995). Therefore, they constantly attempt to make sense of legitimacy requirements conveyed by social actors in the host country. This “sense-making” involves perceiving, learning, and interpreting the assumptions and heuristics of local actors. Hence, local acceptance of the WOFS as a form may act as a belief that exerts a vital influence on the legitimation of particular wholly owned subsidiaries in the host country.

HYPOTHESES

Within-Form Legitimation

The institutional perspective emphasizes that uncertainty increases the importance of social considerations relative to technical ones (Scott, 2001). Moreover, bounded rationality and information asymmetry assumptions make firms more likely to imitate others that are easily observable, similar to themselves, or socially prominent (Haunschild & Miner, 1997). Therefore, foreign investors who are eager to fit in with the host country environment tend to adopt the organizational forms favored by previous FDI entries (e.g. Guillén, 2003; Yiu & Makino, 2002). This isomorphic tendency is likely to be particularly strong among foreign investors from the same industry and home country, as they are bonded by dual identity dimensions (Guillén, 2002; Henisz & Delios, 2001). Hence, the legitimacy of the WOFS form will be enhanced as an increasing number of MNC entries from the same industry and home country take this form.

Institutional processes tend to operate across industries and national borders (e.g., Hannan, Carroll, Dundon, & Torres, 1995), but many prior studies have been unable to examine this broad effect because of the “boundary specification problem” (Laumann, Marsden, & Prensky, 1989). Lee and Pennings (2002), for example, proposed that the diffusion of the partner-associate organizational form within the Dutch accounting sector could be influenced by how foreign accounting firms and other kinds of professional firms, such as law and consulting partnerships, were structured. Although their study could not investigate these influences because of data limitations, they suggested that these higher-level processes should be explored in future studies.

This research focused on national origin and industry type as two dimensions that should help to define the boundaries of distinct organizational identities. The international management literature emphasizes the importance of home country characteristics in molding international expansion, leading to home-country-based mimicry (e.g.,

Guillén, 2002; Yiu & Makino, 2002). Meanwhile, industries can often become “pools of information about the characteristics and behaviors of firms,” and even rivals in an industry can engage in “collective sense-making” (Porac & Rosa, 1996: 370–372). Therefore, when considering international expansion, a foreign firm may regard other foreign investors in the same industry that are already established in the host country as a cognitively relevant identity group and assess the extent to which they have managed to gain legitimacy in the host market under consideration (Fligstein, 1985; Henisz & Delios, 2001).

The legitimacy of the focal WOFS population (same industry and home country) will thus be enhanced with the increasing adoption of this organizational form by foreign investors from: (1) the same community (Community I), (2) the same home country but different industries (Community II), and (3) the same industry but different home countries (Community III). Accordingly, we propose:

Hypothesis 1a. The entry rate of wholly owned foreign subsidiaries into Community I (same industry and home country) is greater the greater the number of such subsidiaries already established in that community.

Hypothesis 1b. The entry rate of wholly owned foreign subsidiaries into Community I (same industry and home country) is greater the greater the number of such subsidiaries already established in Community II (same home country, different industries).

Hypothesis 1c. The entry rate of wholly owned foreign subsidiaries into Community I (same industry and home country) is greater the greater the number of such subsidiaries already established in Community III (same industry, different home countries).

The strength of the influences emanating from the three FDI communities may, of course, be different. McKendrick and colleagues (2003) demonstrated that when the identities of individual organizations are perceptually focused (de novo entries and geographically agglomerated entries are examples of perceptually focused organizations), these organizations more readily cohere into an organizational form with a distinct collective identity, and the legitimacy associated with that organizational form is more readily enhanced. Applying this logic to our three FDI communities, we would expect Community I, with identity overlap on both dimensions, to exert a stronger legitimating influence than either of the other two communities (II

and III), with their single-dimension similarity. Therefore,

Hypothesis 1d. The effect of Community I (same industry and home country) on the entry rate into a host country of wholly owned foreign subsidiaries is stronger than the effects of Community II (different industries, same home country) or III (same industry, different home countries).

Within-Form Competition

According to the organizational ecology perspective, competition may curtail organizational entry into a market when the number of organizations taking a certain form exceeds a threshold (Hannan & Freeman, 1989). Competition occurs when organizations vie for limited common resources (Hawley, 1950: 202). Research in organizational ecology has shown that competition among organizations drawing on the same resource base is systematically linked to economic adversity and organizational failure (Hannan & Freeman, 1989). Therefore, there may be a negative effect on the entry rate of wholly owned foreign subsidiaries into Community I when the number of such subsidiaries already established becomes too large.

On the other hand, this pattern might only be apparent in Communities I and III, where the dimension of industry type comes in. As Simmel (1950) argued, competition among organizations is by and large a function of their positions relative to each other in a resource space. Organizations define relations with other organizations by staking out market niches, an activity that may include claims about clientele served, products and services provided, and technology employed (Levine & White, 1961). Research from the ecological perspective has consistently shown that the potential for competition between any two organizations is proportional to the overlap of their resource bases: the more organizations' niches overlap, the more they require similar resources to survive and thrive, and the more intensely they compete (Baum & Singh, 1994; Hannan & Freeman, 1989).

Industry type is a criterion often used to define market niches, and organizations operating in the same industry are often construed as direct competitors (Hannan & Freeman, 1989). By contrast, home country origin has been found to be a trait that fosters interorganizational mimicry and legitimation without necessarily strengthening competitive pressure (Guillén, 2002; Yiu & Makino, 2002). Therefore,

Hypothesis 2. The entry rate of wholly owned foreign subsidiaries into Community I (same industry and home country) decreases as the number of such subsidiaries in that community and in Community III (same industry, different home countries) continues to increase at a later stage.

Cross-Form Legitimation and Competition

An MNC can also enter foreign markets through joint ventures with local companies, trading ownership for legitimacy in the host market (Yiu & Makino, 2002). Adopting this organizational form will often reduce market uncertainty for the parent MNC and help local partners understand the foreign parent. Over time, increasing experience with local companies not only reduces market uncertainty for MNCs, but also helps legitimate the foreign investor's identity in the host market (Kostova & Zaheer, 1999). Therefore, the JV form will initially have a mutualistic effect and promote the legitimation of the WOFS form as well. This argument is consistent with the findings of recent research in community ecology (e.g., Ruef, 2000), which suggest that the process of form adoption is also subject to population-dependent effects for organizational entries into established populations. However, this momentum may thwart further WOFS entries into a foreign market at a later stage, as WOFSs and JVs residing in the same community often share common resources and thus are, in a sense, competitors. As a result, the number of foreign subsidiaries embracing the relevant yet alternative JV form will promote entry in the WOFS mode up to a point, but in saturated regions of the identity space, further increase in JVs will depress WOFS entries. Therefore, we predict:

Hypothesis 3. The entry rate of wholly owned foreign subsidiaries into Community I (same industry and home country) has an inverted U-shaped relationship with the number of joint ventures in that community.

Public Acceptance of the WOFS Form in a Host Country

In addition to increasing densities in different communities of foreign investors, host country institutions such as standard-setting bodies and public training through media coverage may also help to promote the legitimacy of an organizational form (Kostova & Zaheer, 1999; McKendrick & Carroll, 2001). The legitimacy of the WOFS form in a host country is socially constructed, signifying the ap-

propriateness, acceptability and taken-for-grantedness conferred by local actors, which mainly include government agencies and the general public. Legitimacy evaluated by government agencies is perhaps easier for MNCs to observe, understand, and interpret correctly because it is formalized in laws, rules, and regulations. However, it is much more difficult for MNCs to sense and evaluate to what extent a host country public accepts the WOFS form and perceives this form as appropriate. Opinions of the general public often spring from profound social structures of the host country and reflect widely shared values, beliefs, norms, stereotypes, and social knowledge. Therefore, assessing its legitimacy in the eyes of the public poses a relatively more difficult challenge for a WOFS. Public acceptance of the WOFS form in a host market at a general level signals the extent to which the host market is hospitable to foreign firms taking this organizational form, thus serving as another cue to MNCs seeking foreign entry. Therefore,

Hypothesis 4. The entry rate of wholly owned foreign subsidiaries into Community I (same home country and industry) is greater the greater the extent to which a host country public accepts the wholly owned subsidiary form.

RESEARCH METHODS

Sample and Data Sources

The hypotheses were tested with data covering all foreign-invested manufacturing ventures established in China over the period 1979–95. China is an excellent setting for studying the adoption of the wholly owned foreign subsidiary (WOFS) form for several reasons. First, the data cover the adoption of this form from the beginning of China's economic transition. Second, China's institutional context during the study period is widely considered to have been complex and highly uncertain (Child, 1994). In the face of high environmental uncertainty, social considerations about conforming to the forms that others have embraced to gain legitimacy are of critical importance (Kostova & Zaheer, 1999; Scott, 2002).

The raw data were obtained from the research institute of the Ministry of Foreign Trade and Economic Cooperation in Beijing. This database contains brief profiles of each foreign-invested firm that operated in China in 1979–95, providing information on ownership structure, the national origin of the foreign parent, the industry concerned, and total investment. The empirical study covered foreign-invested ventures in manufacturing industries but excluded those in service sectors, where

the government retained more restrictions on foreign ownership (Child, 1994). Focusing on manufacturing also facilitated comparison with the results of previous studies (e.g., Guillén, 2002; Henisz & Delios, 2001).

The final sample included 85,829 foreign entries from 103 home countries in 27 manufacturing industries (defined at the two-digit SIC level). Among them, 20,633 (24 percent) entered as WOFS and 65,196 (76 percent) were joint ventures. Franchising or licensing ventures were not included in this FDI data set.

The level of analysis of this study—the industry–home country level—facilitated a focus on the adoption of an organizational form by addressing all potential agents, as was consistent with the conceptual framework. The foreign entry data were first aggregated from the subsidiary level to the home country and industry level. Hence, the potential number of country–industry–year combinations was 44,496 (103 countries by 27 industries by 16 years). Following the lead of previous studies, we took the first year of FDI entry in the home country–industry data as the beginning of the observation (Carroll & Hannan, 2000; Henisz & Delios, 2001). The final sample consisted of 5,594 home country–industry–year cells. To correct for potential bias from excluding country–industry cells without any FDI entries in China, we applied a two-stage sample selection technique (Polillo & Guillén, 2005). In the first stage, we estimated the probability of nonzero investments for a given country–industry pair during year t . In the second stage, we included the estimated probability as a control variable to predict the WOFS entry rate. The variables in stage 1 predicting nonzero FDI entries included regulatory changes (industry regulation), changes in expected Chinese growth (industry sales growth in China), the feasibility of producing in China (e.g., the number of local firms in the same industry), and a home country's ability to engage in FDI (gross domestic product [GDP] per capita of an MNC's home country, and home country trade with China). Controlling for this potential

² We estimated a probit model using the longitudinal data set of 2,782 country–industry pairs (103 countries by 27 industries) over 16 years as follows (numbers in parentheses are the standard errors of the coefficients): *Probability of inclusion in the sample* = $-1,205(51.50) + 0.55 \times \text{industry regulation} (0.04) + 0.15 \times \text{GDP per capita} (0.01) + 0.38 \times \text{industry sales growth} (0.08) + 0.60 \times \text{number of local firms} (0.01) + 1.05 \times \text{home country trade with China} (0.03) + 1.58 \times \text{calendar year} (0.07)$. All the regressors except industry regulation were logarithms.

selection bias made us confident that our results would be robust and not biased because of sample selection issues.

Variables and Measures

WOFS entry rate. The entry rate of new wholly owned foreign subsidiaries was taken as a measure of the adoption of the WOFS form, which was the dependent variable. Specifically, we tabulated the number of WOFS entries per year into a particular industry from a particular home country. The WOFS form was defined in terms of 100 percent foreign ownership.

Within-form (WOFS) densities. To investigate the legitimation and competition effects of the three FDI communities, we calculated density measures within the bounded FDI communities. *WOFS density* was measured by the total number of wholly owned foreign subsidiaries from the same home country in the same industry (Community I) in the previous year. *Home-country WOFS density* was measured as the total number of subsidiaries from the same home country but in different industries (Community II) in the previous year. *Industry WOFS density* was measured as the total number of such subsidiaries in the same industry but from different home countries (Community III) in the previous year.

Cross-form (JV) density. Joint venture (cross-form) density was measured as the total number of foreign joint ventures in Community I in the previous year.

Local acceptance of the WOFS form in the host country. Local acceptance of the WOFS form was coded from the index of *People's Daily*, China's official newspaper. We first conducted a key word search and identified a total of 644 articles related to FDI in China over the period 1979–95. Two researchers working independently coded all articles, identifying whether an article addressed issues related to wholly owned foreign subsidiaries in China, and if yes, whether the coverage contained was favorable or unfavorable to the WOFS form. The two raters agreed on about 91 percent of the cases, suggesting high levels of interrater reliability (Deephouse, 1996; Weber, 1990). Consensus was reached on the remaining cases after discussion. We then used the number of articles endorsing wholly owned foreign subsidiaries published in *People's Daily* in the previous year as a proxy for local acceptance of the WOFS form in the host country.

Control variables for economic, political and regulatory factors. As the entry mode literature suggests, regulatory institutions, asset specificity, accumulated experience, and the nature of a host

economy may all influence the choice of the WOFS mode. We included these variables in the study to assess whether or not our hypothesized effects added significantly to the explanations already proposed in the literature. By doing so, we hoped to isolate the dual institutional forces we identified from these plausible and well-established mechanisms. For instance, the entry rate of wholly owned foreign subsidiaries may increase as a host market's institutions and economy develop. Any improvement in the predictability of political, regulatory, and judicial proceedings in China over the study period might, for example, have reduced the need for relational governance (Child, 1994), thus promoting the WOFS entry mode. Similarly, the development of financial and labor markets might have reduced the need for foreign investors to rely on local firms to provide information on and access to these inputs (Khanna & Palepu, 2000). In addition, the opening up of additional provinces or regions to FDI would have led to more bargaining power for foreign investors (Child, 1994). These factors should encourage the adoption of the WOFS form by foreign investors.

In the data analysis, we formulated three measures to capture these influences: an *industry regulative constraint dummy*, *country risk in China*, and *FDI geographic openness*. Even though China's Wholly Owned Foreign Enterprise Law was officially promulgated only in April 1986, China had allowed MNCs to establish wholly owned subsidiaries on an experimental basis in different industries prior to 1986. Therefore, an extensive content analysis of China's WOFS regulations by industry was conducted, and an *industry regulative constraint* dummy variable was coded as a proxy for the timing of industry deregulation permitting wholly owned foreign investment. The lower the regulatory constraints in the host country, the greater the frequency of WOFS adoption that might be expected. As in previous studies (e.g., Pan & Tse, 2000), *country risk in China* was estimated on the basis of the annual credit risk rating published by *Institutional Investor* for the years 1979 to 1995. We used it here as a proxy for development in terms of the rule of law and intermediary markets. *FDI geographic openness* was represented by the degree of geographic diversification, measured as the Herfindahl index of the distribution of FDI among provinces in China (Haveman & Nonnemaker, 2000). This gradual geographic deregulation of FDI might be expected to enhance the bargaining power of foreign investors vis-à-vis the provinces or regions in the host country, thereby encouraging the entry of wholly owned foreign subsidiaries.

Emphasizing the technical environment of entry

mode decisions, transaction cost theory suggests that MNCs are motivated to internalize their transactions and thus to adopt the WOFS form as their asset specificity increases (Anderson & Gatignon, 1986; Hennart, 1988). In the analysis, asset specificity in the host country was approximated at the industry level with two proxies: *R&D intensity* and *advertising intensity* (Delios & Beamish, 1999). Because of data limitations, we coded R&D intensity as a four-year average (1990–94) and coded advertising intensity using data from *China's 1995 Industrial Census*. Both variables, measured as R&D and advertising expenditures expressed as fractions of industry sales, might be expected to exert a positive influence on the adoption of the WOFS form.

Finally, from the organizational learning and capability perspectives, MNCs are more likely to adopt the WOFS form as they accumulate local experience in a host country (Barkema & Vermeulen, 1998; Chang & Rosenzweig, 2001). We calculated *population FDI experience* as the logarithm of the cumulative amount of FDI in Community I to control for this learning effect (Delios & Beamish, 1999). Foreign firms in the same community might be expected to be more likely to adopt the WOFS form as they accumulate local experience in a host country.

Other control variables. Two more industry-level controls were included. *Industry concentration* was measured as the percentage of industry revenues in China accounted for by the eight largest firms. The data came from *China's Top 100 Companies across Industries*, which covers the period 1992–95. We used a four-year average of this ratio to control for industry structure. Industry concentration would be expected to have a negative effect on foreign entries (Caves, 1996). *Annual industry sales growth* was also controlled for in the models, but we expected this variable to have a positive effect on new WOFS entries. The data were obtained from the 1980–96 volumes of the *China Statistical Yearbook*. To control for possible MNC home country heterogeneity, we also included five regional dummy variables in the models (results are not reported to save space). To accommodate the possibility of an autoregressive influence, we also included a lagged term for the dependent variable, *prior WOFS entry*. Finally, a dummy variable was coded as an indicator of any possible “left-censoring” resulting from the FDI communities that

had adopted the WOFS form before 1979, the beginning of our observation period. Among our 5,594 observations, only 68 (1.2%) cases were coded as left-censored. This variable controlled for the possibility that the WOFS adoption pattern of these FDI communities might be different because of selection prior to observation (Ingram & Inman, 1996). We also controlled for WOFS density from different home countries and in different industries in the model.

RESULTS

Table 1 presents descriptive statistics and correlations. Since significant correlations were found among a number of the density variables, we investigated for potential multicollinearity using variance inflation factors (VIFs). The maximum VIF obtained in any of the models was substantially below the rule-of-thumb cutoff of 10 for regression models (Ryan, 1997). Therefore, multicollinearity was not considered an important issue for these results.

Table 2 reports the results of negative binomial regressions (Greene, 1996) modeling the entry rate of WOFSs from the same home country entering a particular industry, incrementally adding the theoretical variables of interest. Model 1 includes all control variables. Model 2 examines the effect of the within-form (WOFS) densities from different FDI communities. Model 3 adds the competitive effects of within-form densities. Model 4 includes the cross-form (JV) legitimation and competition effects. Finally model 5, the full model, introduces the local acceptance of the WOFS form. The significant changes from the baseline value of chi-square seen in the results for models 2–5 suggest that the theoretical variables added significant value to the effects that have been explored in previous studies.

Model 5 shows strong within-form (WOFS) legitimating effects, supporting Hypotheses 1a, 1b, and 1c. The coefficients for WOFS density, home coun-

³ We examined the regression residuals with a standard Durbin-Watson test but did not find significant serial correlations in any of the models.

⁴ We modeled the entry rate of wholly owned foreign subsidiaries using the approach developed in organizational ecology (Hannan & Freeman, 1989). It treats the arrivals of new organizations as a stochastic process and treats the counts of entries at the country-industry level as the unit of analysis. The Poisson process serves as a natural baseline model for organizational entries (e.g., Hannan & Freeman, 1989). However, the variance of the WOFS entry count (21.42) was nearly six times larger than the mean (3.55), a sign of overdispersion (Swaminathan, 1995). To correct for the overdispersion in the data, we used the negative binomial model (see Carroll & Hannan, 2000; McKendrick et al., 2003).

TABLE 1
Means, Standard Deviations, and Correlations for All Variables^a

Variables	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1. WOFs entry rate	3.69	21.84																	
2. WOFs density _{<i>t-1</i>} ^b	0.63	1.13	.54																
3. Home-country WOFs density _{<i>t-1</i>} ^b	2.41	2.16	.36	.79															
4. Industry WOFs density _{<i>t-1</i>} ^b	4.52	1.98	.04	.16	.10														
5. JV density _{<i>t-1</i>} ^b	1.39	1.47	.47	.86	.84	.13													
6. Local acceptance of WOFs _{<i>t-1</i>}	15.18	8.43	.09	.16	.24	.78	.14												
7. Industry regulatory dummy	0.94	0.23	.04	.10	.16	.46	.12	.44											
8. Country risk in China	56.66	2.65	-.04	-.01	-.03	-.13	.02	-.24	-.04										
9. FDI geographic openness ^b	6.43	0.31	.06	.12	.20	.60	.13	.69	.58	-.04									
10. Industry R&D intensity	0.13	0.11	-.01	.00	-.04	-.02	-.01	-.03	-.05	.00	-.06								
11. Industry advertising intensity	0.01	0.01	.01	.04	-.01	.07	.00	.01	.01	.00	.02	-.25							
12. Population FDI experience _{<i>t-1</i>} ^b	1.57	2.73	.28	.76	.65	.13	.65	.16	.10	-.02	.12	.00	.03						
13. Industry concentration/10	10.68	9.29	-.05	-.06	.13	-.27	-.06	.01	-.03	.00	.00	.19	-.45	-.04					
14. Industry sales growth _{<i>t-1</i>}	0.26	0.19	.03	.00	-.04	.04	-.02	.17	-.24	.19	-.02	.08	.05	.03	.05				
15. Prior WOFs entry _{<i>t-1</i>} /100	0.03	0.22	.82	.57	.37	.08	.48	.09	.04	.00	.06	.00	.01	.28	-.05	.04			
16. Left-censoring indicator	0.01	0.11	.27	.16	.09	-.11	.14	-.10	-.13	.00	-.13	-.03	.02	.10	-.06	.03	.26		
17. WOFs density from different industries and home countries _{<i>t-1</i>} ^b	8.47	1.87	.04	.15	.24	.85	.14	.91	.61	-.18	.79	-.04	.01	.13	.00	-.04	.06	-.14	
18. Probability of sample selection	-1.03	0.61	.23	.49	.66	-.04	.65	.07	.15	-.03	.10	-.03	.00	.43	.07	-.05	.21	.01	.07

^a $n = 5,594$. All correlations above $|.03|$ are significant at the 5 percent level. "WOFs" is wholly owned foreign subsidiary. "FDI" is foreign direct investment. "JV" is joint venture.
^b Logarithm.

TABLE 2
Results of Negative Binomial Analysis for Entry Rate of Wholly Owned Foreign Subsidiaries in China, 1979–95^a

Variables	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Legitimacy spillover in FDI communities</i>					
Within-form legitimization					
WOFs density _{<i>t</i>-1}	0.66*** (0.18)	0.54*** (0.03)	0.54*** (0.03)	0.38*** (0.04)	0.40*** (0.04)
Home-country WOFs density _{<i>t</i>-1}	-0.10*** (0.01)	0.33*** (0.02)	0.33*** (0.02)	0.25*** (0.03)	0.25*** (0.03)
Industry WOFs density _{<i>t</i>-1}	0.77*** (0.14)	0.13*** (0.03)	0.16*** (0.03)	0.14*** (0.03)	0.14*** (0.03)
Within-form competition	0.65*** (0.22)				
WOFs density from same industry ² /10 ⁷ _{<i>t</i>-1}	-0.72 (4.29)				
Cross-form legitimization and competition	0.25*** (0.01)				
JV density _{<i>t</i>-1}					
JV density ² /10 ⁷ _{<i>t</i>-1}					
<i>Acceptance in host country</i>					
Local acceptance of WOFs _{<i>t</i>-1}					0.09*** (0.01)
<i>Economic, political, and regulatory control variables</i>					
Industry regulatory dummy					
Country risk in China	-0.11*** (0.01)	0.96*** (0.16)	0.97*** (0.16)	0.95*** (0.16)	1.53*** (0.18)
FDI geographic openness	0.60*** (0.15)	2.00*** (0.24)	1.94*** (0.23)	1.98*** (0.24)	1.12*** (0.17)
Industry R&D intensity	2.27*** (0.16)	0.48** (0.18)	0.42* (0.19)	0.40* (0.18)	0.49** (0.18)
Industry advertising intensity	0.52*** (0.18)	-2.01 (3.63)	-2.05 (3.63)	4.15 (3.69)	6.89* (3.61)
Population FDI experience _{<i>t</i>-1}		0.06*** (0.01)	0.05*** (0.01)	0.06*** (0.01)	0.06*** (0.01)
<i>Other control variables</i>					
Industry concentration/10	0.25*** (0.01)	0.06*** (0.01)	0.05*** (0.01)	0.06*** (0.01)	0.06*** (0.01)
Industry sales growth _{<i>t</i>-1}	-0.29*** (0.03)	-0.27*** (0.03)	-0.26*** (0.03)	-0.20*** (0.03)	-0.18*** (0.03)
Prior WOFs entry _{<i>t</i>-1} /100	0.60*** (0.15)	0.75*** (0.12)	0.77*** (0.12)	0.74*** (0.12)	0.09 (0.13)
Left-censoring indicator	2.27*** (0.16)	-0.07 (0.06)	-0.05 (0.06)	0.09 (0.09)	-0.03 (0.08)
WOFs density from different industries and home countries _{<i>t</i>-1}	0.52*** (0.18)	0.39*** (0.14)	0.37** (0.14)	0.33* (0.13)	0.33** (0.13)
Probability of sample selection	1.11*** (0.05)	-0.43*** (0.04)	-0.46*** (0.04)	-0.43*** (0.04)	-0.76*** (0.05)
Dispersion parameter (α)	1.12* (0.05)	0.26*** (0.05)	0.27*** (0.05)	0.11 [†] (0.06)	0.05 (0.06)
Wald test of coefficient equality		0.52*** (0.06)	0.52*** (0.06)	0.49*** (0.06)	0.44*** (0.06)
Community I > Community II		15.53***	16.36***	6.43**	9.01**
Community I > Community III		68.47***	56.54***	20.61***	24.27***
Community II > Community III		51.81***	31.26***	11.88***	11.15***
<i>df</i>	16	20	21	23	24
Log-likelihood	-6,464.0	-5,982.3	-5,977.2	-5,948.9	-5,875.0
$\Delta\chi^2$ vs. baseline (<i>df</i>)		964.0 (4)***	10.0 (1)***	56.4 (2)***	148.0 (1)***
		Model 1	Model 2	Model 3	Model 4

^a *n* = 5,594. Standard errors are in parentheses. "WOFs," wholly owned foreign subsidiary; "FDI," foreign direct investment; "JV," joint venture. Models with regional dummies not reported.

[†] *p* < .10
* *p* < .05
** *p* < .01
*** *p* < .001.

try WOFS density, and industry WOFS density are all positive and significant. Therefore, the decision to adopt the WOFS form for a new investment is positively related to the number of these subsidiaries already operating in FDI communities I, II, and III. To test Hypothesis 1d, we conducted Wald tests comparing the strength of the legitimating influences from the three FDI communities (Greve, 2002), and Community I was indeed found to have the strongest legitimating impact on the entry rate in the WOFS form. The effect of Community II was in the middle, and the effect of Community III was the weakest (Table 2). Therefore, Hypothesis 1d was supported. Figure 1 plots the predicted effects on the WOFS entry rate of the three FDI communities and illustrates that Community I exerts the strongest legitimacy influence. For example, when the Community I density increases one standard deviation from its mean, it enhances the multiplier of WOFS entry in the focal population 1.3 times. When the density in Community II raises one standard deviation above its mean, it increases the multiplier by an extra 60 percent. The multiplier effect of Community III density with one standard deviation change is even smaller, increasing only 10 percent.

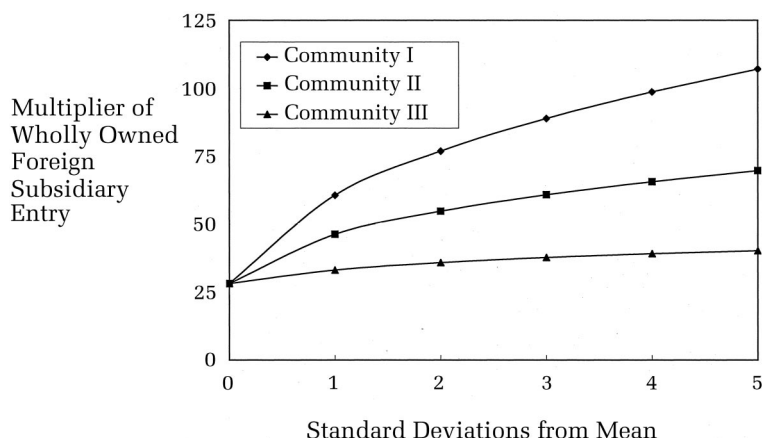
In terms of within-form competition effects, the significant and negative coefficient of the square of WOFS density indicates that as the number of subsidiaries in the same industry (Communities I and III) further increases, the WOFS entry rate declines, supporting Hypothesis 2. Hypothesis 3, on the cross-form legitimation and competition effects of JV density, was also supported. The results show that the coefficient of the linear term was signifi-

cantly positive, and that of the squared term was significantly negative. Foreign joint ventures, as an alternative organizational form, helped to legitimate the wholly owned form in China initially. However, as the number of joint ventures increased, competition emerged, with the two organizational forms vying for similar resources. Hypothesis 4, predicting a positive effect of local acceptance of the WOFS form on the rate of entry in this form, received strong support.

Several control variables representing other factors suspected of influencing the rate of WOFS entries also showed the expected effects. The regulatory dummy had a positive effect on new WOFS entries, in keeping with expectations. Greater country risk in China was related to lower WOFS entry rates, and geographic openness enhanced WOFS entry. As expected, significant effects were found for industry-level R&D intensity and advertising intensity. As a proxy for accumulated experience, FDI investment experience was found to be positively related to the rate of WOFS entry, confirming expectations.

Local industry concentration was negatively related to the entry of WOFSs in China. MNCs may avoid entering industries dominated by a few large domestic players. The result may also suggest that the legitimacy of the WOFS form might be more difficult to establish in highly concentrated industries. Further studies are needed to clarify this important issue. As expected, local industry growth was also found to affect new WOFS entries, with foreign investors entering high-growth industries. Two additional control variables also showed expected effects: the left-censoring indicator had a

FIGURE 1
Multiplier Effects of FDI Community Densities on Entry Rate of Wholly Owned Foreign Subsidiaries^a



^a The means and standard deviations of densities in Communities I, II, and III were (8, 60), (226, 1,087), and (338, 559), respectively. The minimum and maximum numbers in the three communities were (0, 2,449), (0, 11,610), and (0, 3,653), respectively. We computed multipliers using the significant coefficient estimates of key theoretical variables from model 5 of Table 2.

strong and positive effect, and the number of WOFS entries in different industries and from different home countries showed a negative effect. Furthermore, our two-stage model controlling for the probability of sample selection verified the robustness of our results.

DISCUSSION AND CONCLUSIONS

Theoretical Contributions and Practical Implications

As discussed at the outset, our purpose in this study was to examine how wholly owned foreign subsidiaries gain legitimacy as an organizational form over time in a host country, a topic that has been largely ignored in the international management literature. Following Pólos and coauthors' (2002) work, in which forms are defined as a type of socially coded identity, we conceptualized wholly owned foreign subsidiaries as a distinct organizational form and examined influences on the adoption of the WOFS form in China over 1979–95. The two influences at the focus of our attention were peer foreign investors and host country receptiveness. Our findings reveal that the adoption of the WOFS form in China hinged on the legitimation and competition dynamics of FDI communities, as well as on Chinese acceptance of the WOFS form.

The results show that the adoption of the WOFS structure was promoted by the existence in the market of prior foreign wholly owned subsidiaries from the same home country and in the same industry (Community I), from the same home country but in different industries (Community II), and in the same industry but from different home countries (Community III). Entry in WOFS form was discouraged by competition from prior WOFS entries in the same industry (Communities I and III). As a relevant alternative organizational form, foreign joint venture entries exerted similar impacts: the entry of new WOFSs increased initially as the number of already-established JVs increased but decreased later as the number of JVs passed a threshold. In addition to the legitimating influence stemming from the various FDI communities, the results also confirmed the role that host country receptiveness plays in the adoption of the WOFS form: the greater the acceptance of the WOFS form in the host country, the more foreign investors adopted this form.

Conventionally, researchers have posited that organizations with common traits or characteristics tend to follow the actions taken by their peers and reference groups to ameliorate uncertainty in the institutional environment, thus facilitating the le-

gitimation of an organizational form (DiMaggio & Powell, 1983; Guillén, 2002, 2003; Haunschild & Miner, 1997; Henisz & Delios, 2001). In short, similarity leads to isomorphism in organizational form. Going one step further, this study argues that a theoretical construct underlies these traits or characteristics that organizations have in common: organizational identity. Organizations sharing a common identity constitute an organizational community, and organizational proliferation in the community precipitates the adoption of the corresponding organizational form (e.g., Carroll & Hannan, 2000; Ruef, 2000). Organizations with related identities then influence each other in proportion to their distance in the identity space, with focused or overlapping identities exerting a stronger influence (McKendrick et al., 2003; Ruef, 2000).

Beyond organizational proliferation within a community, external audiences such as standard-setting bodies, the media, and the general public are also influential in legitimating an organizational form, as they possess sanctioning power if the social codes associated with the organizational form are violated (e.g., McKendrick & Carroll, 2001). By synthesizing institutional and ecological approaches, this study has built a coherent theoretical framework for considering the legitimation of an organizational form, combining identity, community, and audience as threads. In our research design, we specified this framework as having two components: legitimacy spillover from other cognitively relevant foreign investors, and public perception and acceptance in the host country. This specification addresses the concern that international research has not received adequate attention in the formulation of organizational theories (e.g., Guillén, 2002; Henisz & Delios, 2002).

Our empirical findings suggest that the FDI community concept helps explain the effects of peer foreign investors on the legitimation of the wholly owned foreign subsidiary form in a host country, thus directly addressing the boundary specification problem that has constrained many previous institutional studies (Laumann et al., 1989). The findings suggest the importance of examining these higher-level institutional processes. And they also provide additional empirical evidence for Hannan et al.'s (1995) finding that institutional processes can exert influences in a broader social context. Second, both the population of WOFSs per se and the JV population have been shown to be related to the rate of entry in the WOFS form. The effects are double-edged: legitimation from both forms spurs further WOFS entries, and competition from both forms deters further entries. This pattern echoes the findings of previous community ecology studies

(e.g., Ruef, 2000) and indicates that similar dynamics operate across different organizational forms.

Another interesting finding is the identity dependence of legitimation for WOFSs. As noted before, WOFS Community I, defined by identical MNC national origin and industry type, can be considered as grouping firms with multiple organizational similarities, but Communities II and III have only single-dimension similarity. The results show that Community I indeed exerts a stronger legitimation influence than Communities II and III. These results extend McKendrick et al.'s (2003) findings by directly comparing the differentiated influences of different communities on the legitimation of an organizational form. This identity-dependent legitimation process can thus be regarded as a more refined theoretical foundation for investigating the adoption of the WOFS form and similar research questions.

The positive relationship between the adoption of the form of interest and public acceptance of wholly owned foreign subsidiaries in a host country supports the idea of organizational legitimacy under conditions of complexity in the international context (Kostova & Zaheer, 1999). The legitimacy inferred from the general public in a host country has been extensively discussed in the international literature, but this has been the first study to apply a rigorous empirical test. Our study is thus one of the first to operationalize this theoretical construct in an international context. Responding to the call for more empirical attention to organizational legitimacy (Suchman, 1995), we have refined the propositions to reflect different types and sources of organizational legitimacy in the international context.

It is also of importance that this study examined the influences of economic, political, and regulatory factors in a host country on the adoption of the WOFS form. The results accord with the findings of previous entry mode studies. For instance, the positive association between industry-level asset specificity and WOFS adoption verifies the transaction cost argument that increasing asset specificity tends to stimulate MNCs to internalize their transactions and thus to adopt the WOFS form as they initiate foreign entry strategies (Anderson & Gatignon, 1986; Dunning, 1993; Hennart, 1988; Williamson, 1975). Also, the positive association between accumulated host country experience and the entry rate of wholly owned foreign subsidiaries corroborated the organizational learning and capability perspective (Barkema & Vermeulen, 1998; Chang & Rosenzweig, 2001). All these findings suggest that our theoretical variables can add significantly to the effects that have been manifested in

conventional entry studies. Moreover, by drawing heavily on macro organizational theories and synthesizing them with ideas drawn from the international management literature, this study enriched understanding of macro organizational theories in the international context, as well as further extending the traditional conceptualization of foreign entry modes.

And finally, recognizing an important limitation in previous studies on strategic choice in general and entry modes in particular (Hamilton & Nickerson, 2003; Shaver, 1998), we applied the two-stage sample selection technique in which stage 1 predicts whether entries are nonzero and stage 2 predicts the entry count (Polillo & Guillén, 2005). To correct for a potential sample selection bias, in our stage 1 model we included variables such as regulatory changes, changes in expected Chinese growth, feasibility of producing in China, and capabilities of MNCs' home countries to engage in FDI in China. By controlling for this potential selection bias, we became confident that our results on legitimacy effects are robust and that possible alternative explanations for these key results can be ruled out.

The results of this study have implications for managers and government policy makers. The findings suggest that to understand the evolution of WOFSs over time in a host country, it is important to consider higher-level institutional processes (e.g., FDI communities and host country institutions), in addition to firm-level factors. The finding that different FDI communities influence legitimacy to varying degrees also has important implications. When considering foreign expansions, firms will find the concept of FDI communities developed in this paper, as well as the notion of identity overlap, useful for identifying the most relevant populations of firms as peers influencing their entry decisions. Furthermore, a host country's acceptance of foreign investments, often reflected in public opinion as expressed in the media, is an important source of legitimacy for foreign investment, in addition to formal regulations and policies.

Though these implications could apply to many other national contexts and industry settings, the findings of this study provide particularly useful insights for enterprises operating in emerging markets. An emerging economy is characterized by rapid economic development and by government policies favoring economic liberalization and the adoption of a free-market system (Arnold & Quelch, 1998; Scott, 2002). In an emerging host market, as FDI communities are becoming mature and public acceptance of the WOFS form becomes wide-

spread, enterprises in this emerging economy that were formerly state-owned are facing strongly coercive environmental forces as they adapt to the competitive pressures of a market-based and open economy (Hoskisson, Eden, Lau, & Wright, 2000; Peng, 2003). When local enterprises respond by launching strategies for restructuring, downsizing, and adaptation to Western practices, well-rounded consideration of the legitimation and competition dynamics of foreign-invested firms would enrich their pool of decision-making heuristics, help them locate the most relevant foreign peers as benchmarks, and better use economic liberalization as their primary engine of growth.

Limitations and Future Research

Despite the promising results and useful implications, this study was limited in several ways that suggest areas for future research. First, both the host country environment and the MNC parent network are likely to influence the legitimacy of different forms of foreign subsidiary (Kostova & Zaheer, 1999). Although the focus in this study was on the legitimacy of a particular entry mode in a particular host country, future research should examine how the legitimacy of the WOFS mode within the MNC parent network affects its adoption, particularly in comparison with alternative entry modes such as joint ventures.

Second, because our theoretical interest in the legitimation of an organizational form required us to focus on a population level of analysis, we were limited in this study to examining effects of firm-level variables. In fact, population-level and firm-level studies, though addressing different research questions, should complement each other. We have included several population-level proxies as controls in this study, but future research with finer-grained data and measures might be expected to shed additional light on these important issues. Third, although we investigated the cross-form interactions between two entry modes (WOFS and joint venture) in this paper, our fundamental theoretical interest was how wholly owned foreign subsidiaries gained legitimacy over time in a host market, not the two modes' relative legitimacy. Therefore, exploring the changes in the relative legitimacy of different entry modes would be another interesting area for future research.

In summary, this study provides insights about the adoption of the WOFS as a FDI entry mode in an emerging economy. The core logic of the present study—that the sources of legitimating influences are dual—can be applied to a number of other related topics, such as the legitimation of FDI loca-

tion choice, use of expatriate managers, and diffusion of human resource management practices. These should be interesting topics to be explored in future studies.

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