Knowledge transfer, regulatory support, legitimacy, and financial performance: The case of foreign firms investing in China

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ABSTRACT

This study aims to link the knowledge-based view and the legitimacy perspective in order to explore the determinants of knowledge transfer and regulatory support. We then examine their consequences within a systematic framework drawing upon the institutional view. Examining a sample of 102 Taiwanese manufacturing firms operating in China, the study finds that both knowledge transfer from local suppliers and regulatory support from local governments help foreign firms to enhance their financial performance. The combination of trusting relationships with local suppliers, a foreign firm's knowledge stock, and agglomeration encourage local suppliers to transfer knowledge. Additionally, foreign firms' knowledge stock is significantly related to regulatory support.

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1. Introduction

Promoting the transfer of knowledge from local suppliers and attaining regulatory support from local governments are both critical challenges for foreign firms initiating international business operations. Although the traditional literature on the knowledge-based view (KBV) has offered powerful explanations of the determinants of knowledge transfer, legitimacy remains an important but largely ignored subject (Dacin, Oliver, & Roy, 2007). Legitimacy refers to the social justification and the public endorsement of an actor or activity (Suchman, 1995). The purpose of this study is the integration of these two perspectives—the knowledge-based view (KBV), and the legitimacy function—for a better understanding of cooperation with suppliers and governments, as well as an examination of their impact on foreign firms' performance.

Aldrich and Fiol (1994), Suchman (1995), Child and Tsai (2005), and Kumar and Das (2007), advert that the perception of foreign firms' legitimacy can be cultivated. Applying this notion, we treated trusting relationships with suppliers as a driver in the acquisition of moral legitimacy,[2] the knowledge stock of foreign firms as an aid in gaining pragmatic legitimacy, and agglomeration

as illustrative of the importance of local acceptance and "taken-for-granted" routines of behavior in local environments, which helps in the acquisition of cognitive legitimacy.

Existing studies taking the KBV have shown that the characteristics of the transferring actor (Kotabe, Martin, & Domoto, 2003; Zander & Kogut, 1995) and the receiving actor are of primary importance in the transfer of knowledge (Gupta & Govindarajan, 2000; Zander & Kogut, 1995). These studies, however, generally were conducted in developed countries, in which a relatively stable, market-based institutional framework (Peng, Wang, & Jiang, 2008) can reasonably be assumed. However, emerging economies are typically characterized by the lack of a property-rights-based legal framework, an underdeveloped institutional infrastructure, and economic and political instability. The scripts, rules, and norms of the market-based system are not well established in these economies. There is a greater degree of uncertainty and risk for foreign manufacturers, making it more difficult for them to persuade local suppliers to transfer knowledge or information to them. Foreign firms must understand how to acquire the legitimacy they need to "play the game" in a new, unfamiliar market (Wright, Filatotcher, Hoskisson, & Peng, 2005).

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[2] Suchman (1995) has suggested that moral legitimacy may take four forms: evaluations of outputs and consequences (e.g., consumer judgments of quality and value, as well as treating employees fairly), evaluations of techniques and procedures (e.g., socially accepted techniques, procedures and values), evaluations of structures (e.g., structural characteristics within a favored taxonomic category), and evaluations of leaders and representatives (e.g., charisma of individual organizational leaders). While Suchman (1995) has identified several forms of moral legitimacy, the range of moral criteria remains quite broad (Zimmerman & Zeitz, 2002; Suchman, 1995). Given the fact that our goal is to encourage knowledge transfer by suppliers, we chose to use trusting relationships as our proxy for moral legitimacy.

Additionally, foreign firms also need recognition from local governments if they are to attain regulatory support. This is especially true in China (Buckley, Clegg, & Tan, 2006). China is often noted for its somewhat arbitrary enforcement of legal and governmental regulations. If foreign firms can gain regulatory support from local governments, their performance may well be improved. Further, when it comes to the determinants of regulatory support, knowledge stock and agglomeration might help firms achieve pragmatic and cognitive legitimacy, which are related to perceptions of such attributes as the firm's provision of a "good experience," its positive reputation, or its ostensible success (Dacin et al., 2007). Local governments, perceiving the beneficial possibilities of relationships with such firms, would be more likely to offer regulatory support. While the importance of both knowledge transfer from suppliers and regulatory support from governments has been recognized, very little research has incorporated these two topics within a systematic framework (Luo, 2001). This study aims to link the KBV and the legitimacy perspective to explore the determinants of knowledge transfer and regulatory support, as well as their consequences. Practically, we provide some suggestions for foreign firms to help them create cooperative relationships with local suppliers and governments in China.

2. Literature review and research hypotheses

2.1. The legitimacy perspective

The importance of legitimacy lies in the provision of a basis for strategic actions. This perspective assumes that bounded rationality and uncertainty is the basic condition in societies and business organizations (Zimmerman & Zeitz, 2002). When facing uncertain environments, organizations turn to the stock of scripts, rules, norms, and values which are embedded in social institutions (Zimmerman & Zeitz, 2002). These define appropriate legitimation activities (Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004). Traditional institutional researchers have suggested that legitimacy is not an operational resource, and have chosen to focus instead on the pressure for conformity to constitutive beliefs (Dimaggio & Powell, 1983). While firms should obviously obey the pertinent laws, rules, and norms, the use of strategic behaviors to obtain legitimacy has not been widely considered by researchers (Phillips, Lawrence, & Hardy, 2000). Further, given the high uncertainty associated with emerging economies, it is inappropriate to assume that institutions are operating in the context of a given "background" (Peng et al., 2008). Several studies have started to examine the influence of legitimacy on foreign entry strategy (Lu & Xu, 2006; Li, Yang, & Yue, 2007). While the choice of entry mode is critical, cooperation with local partners to acquire complementary resources becomes a major concern once entry has occurred (Peng & Heath, 1996). Recent studies have provided theoretical conceptual models (Dacin et al., 2007; Hitt et al., 2004; Kostova & Zaheer, 1999; Zimmerman & Zeitz, 2002) and case evidence (Ahlstrom, Bruton, & Yeh, 2008; Phillips et al., 2000) for organizational legitimacy associated with collaborative relationships. Building on the existing literature, we posited that legitimacy is an important resource for gaining other external resources (i.e., knowledge from local suppliers and regulatory support from local government), and, in turn, enhances the financial performance of foreign firms.

Existing studies on knowledge transfer have focused on acquiring advanced and unique knowledge from firms in developed countries. In contrast, foreign firms investing in emerging economies generally do not aim to acquire cutting-edge technology. Further, foreign firms' capabilities may be, objectively speaking, greater than their local suppliers'. Foreign firms, however cannot possibly internalize all of the activities necessary for the production of their goods because of differing economies of scale. Each firm's specializations lie in different domains. To achieve market entry and survive, foreign firms should cooperate with local partners (Ojala, 2009). Under such circumstances, suppliers can play a role in designing components and manufacturing processes that match foreign firms' idiosyncratic designs (Clark & Fujimoto, 1991). Knowledge transfer might occur as the application of suppliers' valuable technology to the commercial end of a foreign firm's goods.

Motivating local suppliers' knowledge transfer should be interdependent with interpartner legitimacy, relating to a mutual acknowledgement of the expectation of appropriate behavior on the part of both partners (Kumar & Das, 2007). While some reasoning from the legitimacy perspective may be consistent with the characteristics of the relationship between transferor and recipient derived from the KBV, legitimacy-based reasoning provides more comprehensive information about the functions of an institution for cooperation with partners (Dacin et al., 2007).

Legitimacy, including a set of institutional domains, is generally thought to be divisible into three categories: moral, pragmatic, and cognitive (Suchman, 1995). Moral legitimacy has to do with the positive normative evaluation of a firm and its activities. Pragmatic legitimacy is associated with the self-interested calculations of a firm's supplier. Cognitive legitimacy has to do with the degree to which a firm's presence is regarded as a "given," or can be "taken for granted" within an institutional environment. While these different sorts of legitimacy may be not directly observable, they reside within the "psyches" of social actors (Zimmerman & Zeitz, 2002, p. 418). In this regard, managers of foreign firms operating in uncertain environments might fall back on the social rules accepted in Chinese society, reflecting cultural alignment or consonance with relevant norms (Zimmerman & Zeitz, 2002).

As Chinese society emphasizes *guanxi,* trusting relationships with suppliers may be used to build moral legitimacy. Due to a focus on long-term economic development, technical expertise can drive pragmatic legitimacy; thus we assess the effect of a foreign firm's knowledge stock. Given the relative underdevelopment of China's institutional environment, cognitive legitimacy can be judged according to the density of a particular group of firms (Suchman, 1995). Along these lines, we adopt agglomeration as its proxy. Next, we set out to further analyze the impact of trust, knowledge stock, and agglomeration, respectively.

2.2. Hypotheses

Trusting relationships refer to a sort of expectation that alleviates the fear that one's exchange partner will act opportunistically (Tsai & Ghoshal, 1998). Such relationships serve as an informal means to reduce uncertainties in economic exchanges. These ideas are related to moral legitimacy. Specifically, if moral legitimacy is to be achieved, firms must conform to their partners' existing principles. It is on the basis of such principles that firms form judgments about one another, and about whether cooperation will prove beneficial (Suchman, 1995). Trust is the basis on which the code of conduct existing between firms is established. In the context of this study—i.e., that of emerging economies where the price system does not accurately provide signals of effective trading exchanges—the development of capabilities for relationship-based management may well emerge (Hoskisson, Eden, Lau, & Wright, 2000). The Confucian tradition of collectivism in China may also encourage exchange partners to place significant emphasis on *guanxi* (referred to as "trusting connections" in this study) as a way of doing business (Buckley et al., 2006; Park & Luo, 2001).

Trusting relationships based on shared values (Tsai & Ghoshal, 1998). Shared values help to develop a body of experience that lets

firms know which resources to contribute, and how to contribute them (Kotabe et al., 2003). The bilateral appreciation involved in trusting relationships also helps to create the shared expectation that each partner will work toward mutually agreed-upon goals, and within mutually agreed-upon boundaries (Aldrich & Fiol, 1994). In the context of such a system—that is, one in which collaboration is viewed as an act of benevolence—partners would be likely to share knowledge with one another (Suchman, 1995).

Hypothesis 1. Trusting relationships with suppliers are positively related to knowledge transfer from local suppliers to foreign firms in a host country.

Pragmatic legitimacy refers to the reality that firms must identify and attract partners who value the potential exchange they provide (Suchman, 1995). The government of China, transferring from a command economy to a more market-based system, has provided a supportive institutional environment by encouraging local firms to internalize advanced resources and capabilities from their partners, helping them to compete in the long term (Hitt et al., 2004). In such an institutional environment, Chinese suppliers may prefer to collaborate with foreign firms possessing high-value knowledge stock when it comes to accessing and participating in global markets and technological processes (Luo, 2001).

Given the liabilities of foreignness, local firms have only limited information about foreign firms' track record. Managers are unable to employ the standard set of financial and rational judgments. Several studies have suggested that the possession of technical expertise (Ruef & Scott, 1998), the manipulation of product advertisements (Suchman, 1995), and links to partners with substantial reputations (Lu & Xu, 2006) have improved focal firms' pragmatic legitimacy. We suggest that the possession of knowledge stock capable of creating sustainable profitable advantages is not only an important indication of a foreign firm's innate reliability, but also a way of helping local suppliers survive and prosper. Huang, Hu, and Chen (2008) found that resource embeddedness centered on product knowledge and market knowledge would lead to long-term cooperation with partners. Indeed, suppliers may well be more likely to transfer their knowledge to firms having such characteristics.

Hypothesis 2. Foreign firms' knowledge stock is positively related to knowledge transfer from local suppliers in a host country.

Cognitive legitimacy has to do with the particular identity a firm establishes, as well as with whether the activities in which the firm participates are accepted or permitted (Ruef & Scott, 1998). In this regard, selecting an environment in which a firm can attract or associate with potentially friendly audiences may be an easier way to achieve cognitive legitimacy (Ahlstrom et al., 2008; Suchman, 1995). Agglomeration is an indication of the acceptance of a firm, at least according to its own regional–cultural norms (Aldrich & Fiol, 1994; Suchman, 1995). Due to the intense and varied contact that occurs within an agglomeration, certain patterns of activity would become established, and partners would come to understand one another. Out of such interactions, firms would begin to build distinct identities.

The notion of a particular agglomeration has been applied to define the boundaries of legitimation (Pouder & John, 1996). Firms located in geographic "hot spots" would gain closer and more frequent access to a variety of knowledge. This would allow them to learn how to behave in an isomorphic manner and improving their cognitive legitimacy (Pouder & John, 1996). Along these lines, locating within a particular agglomeration helps local firms understand foreign firms' behaviors. Local suppliers may come to gain confidence in the predictability of manufacturers'

behaviors. Collaboration is then likely to be achieved, and suppliers may be persuaded to transfer important knowledge.

Hypothesis 3. Agglomeration is positively related to knowledge transfer from local suppliers to foreign firms in a host country.

Beneficial regulatory support does not come out of nowhere; actors must first achieve pragmatic legitimacy. Foreign firms should become involved contributors in the local community, complying with the stated needs and priorities of the local government. Given that economic development is frequently a local governmental priority in China, a foreign firm's knowledge stock can function as a strategic response to such institutional pressure from government authorities (Luo, 2001).

We are operating from the assumption that knowledge stock would help to establish a firm's reputation as a rent-gaining actor, and, accordingly, as a local-tax- and economic-growth-generating contributor. When foreign firms possess greater stocks of knowledge, they are better able to negotiate with local governments for favorable regulatory treatment (Child & Tsai, 2005). The resource dependence perspective likewise holds that desirable knowledge stocks lead local governments to exercise some restraint in the manner and extent to which they apply local regulations to foreign firms (Child & Tsai, 2005; Pfeffer & Salancik, 1978).

Hypothesis 4. Foreign firms' knowledge stock is positively related to the regulatory support provided by local governments.

Drawing from the cognitive view associated with institutions, the legitimacy of foreign firms in a host country is socially constructed, signifying the appropriateness, acceptability and "taken-for-grantedness" conferred by local actors (Li et al., 2007). Agglomeration may help foreign managers make sense of their environments, as well as help them to respond appropriately to legitimacy requests from local governments. First, agglomeration creates an environment in which firms must rapidly accede to institutional rules. Because of the way that information moves through agglomerations, firms will begin to adopt organizational forms, structures, policies, and practices similar to those of other firms within the region, in order to achieve legitimacy among their peers (Dimaggio & Powell, 1983). Second, agglomeration allows firms to achieve both legitimacy and favorable regulatory terms as a result of collective bargaining with the local host government. Similarly, Zimmerman and Zeitz (2002, p. 422) suggested that firms can select microenvironments and take steps to influence public opinion or local governmental regulations. Third, agglomeration is associated with greater chances of firm survival (Porter, 1998; Pouder & John, 1996). These positive outcomes are generally thought to be the result of agglomeration-related regional-specific benefits including low-cost labor, specialized suppliers, well-established infrastructure, and competitive incentives. In sum, as foreign firms within agglomerations are likely to gain legitimacy, it is more likely that favorable regulatory support will be attained.

Hypothesis 5. Agglomeration is positively related to local governments' provision of regulatory support.

The key point behind the five hypotheses is that different dimensions of legitimacy tend to influence suppliers' knowledge transfer and governments' regulatory support. In the following sections, we will elaborate upon the ways in which knowledge transfer and regulatory support influence a foreign firm's financial performance.

The transfer of knowledge from local suppliers helps foreign firms to receive useful skills and information. According to KBV, several descriptive studies have suggested that the sharing of technical know-how and information creates value for manufac-

turers such as greater end-product quality and the development of new products (e.g., Clark & Fujimoto, 1991; Zander & Kogut, 1995). Claro, Hagelaar, and Omta (2003) found that joint planning and problem solving between suppliers and manufacturers often leads to the exchange of information and know-how. These behaviors lead to the enhancement of foreign firms' financial performance. Lee and MacMillan (2008) also found that a positive relationship between knowledge transfer and a foreign subsidiary's performance. Further, because of foreign firms' lack of familiarity with local business environments, suppliers can play a key role in transferring both explicit and implicit information or knowledge about competitors to foreign firms. Lindstrand, Eriksson, and Sharma (2009) also have highlighted the usefulness of knowledge supplied by partners networks for a focal firm. If foreign firms can acquire information about their competitors and learn how to operate in a new local environment, their financial performance is likely to be bolstered.

Hypothesis 6. The transfer of knowledge from local suppliers is positively related to foreign firms' financial performance in a host country.

Emerging economies are generally known for the institutional constraints imposed by local governments (Child & Tsai, 2005). Peng and Heath (1996) further noted that China's governmental regulatory regime is perceived by managers as one of the most influential, complex, and unpredictable environmental factors. Specifically, the enforcement of regulations is, to some extent, subject to government officials' interpretations. Local governments can either interfere with the reallocation of capital and critical raw materials (Park & Luo, 2001), or exempt foreign companies from paying local income taxes (Luo, 2001). If foreign firms with healthy ties to local governments can gain favorable regulatory support, superior performance might be realized (Park & Luo, 2001). Further, dysfunctional competition is not uncommon, as many firms engage in opportunistic and unlawful behaviors (Li & Zhang, 2007). Buckley et al. (2006) held that strong political relationships could be useful in garnering favorable outcomes when conflicts occur among firms and could mitigate the negative impact of dysfunctional competition, and positively impact firm performance.

Hypothesis 7. Regulatory support from local governments is positively related to foreign firms' financial performance in a host country.

Fig. 1 graphically summarizes our theoretical logic.

3. Research methodology

3.1. Samples and data collection

This study surveyed a sample group of Taiwanese manufacturing firms[3] investing in China. We believe that, for two reasons, Taiwanese manufacturing firms operating in China can be regarded as foreign manufacturing firms. First, China continues to aggressively court foreign direct investment (FDI). Second, Taiwanese manufacturers have become one of the most important

Fig. 1. Conceptual model.

sources of FDI in China, ranking as China's fifth largest foreign investor (Investment Commission, 2006).

Our study used a two-part survey, part of which was administered through the mail, and part of which was administered via commercial banks.[4] After removing 379 non-manufacturing firms from the list, we selected 450 firms by means of systematic sampling from the list of *Taiwanese firms investing in China 2005* (Investment Commission, 2006). We mailed our questionnaires directly to the appropriate executives. This procedure resulted in the return of forty-five usable questionnaires, a response rate of 10 percent after accounting for undeliverable surveys. As much as possible, a standard procedure was also used to collect the data through foreign-exchange and banking service counters. Initially, key people from each bank were sought to help administer the survey. Surveys were given to a random sample of Taiwanese manufacturers investing in China. A letter was attached explaining the objective of the questionnaire. Of the 65 responses, 57 questionnaires were useful. To avoid the demand effect, we took action to ensure that the respondents whom the authors accessed from the banks did not have any personal connection to the researchers. None of the banks provided any financial support for the study. In the end, our total sample consisted of 102 questionnaires. There were no significant differences between the two groups of respondents (i.e., mailed survey and survey via commercial banks) in terms of the constructs under study ($p > 0.05$). The final sample involved the Taiwanese manufacturing firms, and showed that 42 of the firms had fewer than 500 employees, 29 had between 501 and 1500 employees, and 31 had more than 1501 employees. We also combined the two groups together and assessed firm size and industry classification with those of the general population, as published by the Investment Commission (2006). Chi-square tests showed that there was no difference between our samples and the population ($p > 0.05$).

3.2. Measurements

During the development of our questionnaire, we consulted extensively with executives from Taiwanese manufacturers investing in China, and we also referred frequently to the existing

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[3] Our data did not provide information about whether the responding Taiwanese firms were original equipment manufacturers (OEMs) or suppliers to OEMs. While both OEMs and OEM suppliers need complementary resources from local suppliers and governments, they may adopt different criteria in selecting suppliers. OEMs emphasizing product-design and product-development may work with suppliers who can provide innovative components; OEM suppliers tend to focus on cost and may look for suppliers offering low cost components. Because few Taiwanese firms market their products with their own brands, we were confident that most of the firms examined were OEM suppliers.
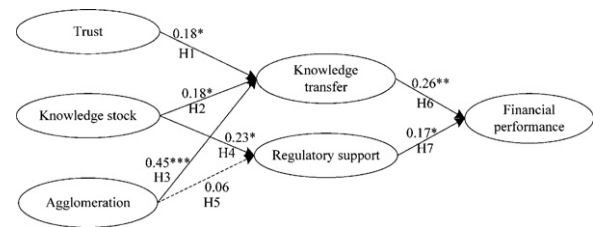
[4] We chose to split the survey for the following reasons. First, when we examined China's and Taiwan's governmental statistics on the number of Taiwanese firms investing in China, we found two very different figures. One figure, coming from the report *Taiwanese firms investing in China* 2005 (Investment Commission, 2006), indicated 2308 such investments. The second figure, coming from the *China Statistical Yearbook* (National Bureau of Statistics, 2006), indicated that more than 68,000 such projects had occurred. Gao (2007) and several Taiwanese government officials explained this enormous discrepancy by pointing out that Taiwanese firms often engage in FDI privately or informally. Thus, in order to include firms engaging in FDI through both formal and informal means, this study collected data from Taiwan's government reports as well as through two banks which provide foreign-exchange and banking services to Taiwanese firms with operations in China. While collecting data from two banks might sacrifice some degree of external validity (Cook & Campbell, 1979), we felt it was important to find some means of considering those Taiwan-China investments not in the Taiwanese governmental list. Other researchers (e.g., Levin & Cross, 2004) have employed banks in their research, using bank employees or external relationships to examine their hypotheses.

literature. We then carried out a trial test at two Taiwanese manufacturing firms in which managers and owners were asked to fill out the questionnaire and to raise questions as problems or ambiguities arose. This information was used to further improve our questions and scales. Our study measures its constructs using a 7-point Likert scale, with 1 indicating "strong disagreement" and 7 indicating "strong agreement."[5]

Financial performance: Many researchers have used managers' perceptions to measure financial performance (e.g., Lane, Salk, & Lyles, 2001; Luo, 2001) in terms of sales, profits, and market share. While other researchers have preferred to use objective data such as market values and return on assets (e.g., DeCarolis & Deed, 1999), several scholars have suggested that there is a high correlation between objective and subjective data on performance (e.g., Venkatraman & Ramanujan, 1986). Given the availability of data, the operationalization of performance in our study was developed in parallel with that of Lane et al.'s (2001) and Luo's (2001) studies. A three-item scale was used to assess the degree to which (1) we are satisfied with our profit rates (FP1); (2) we are satisfied with our sales growth rates (FP2); and (3) we are satisfied with our firm's market share (FP3).

Knowledge transfer: Following Levin and Cross (2004) and Simonin (2004), knowledge transfer from suppliers relates to the receipt of useful knowledge helpful to key aspects of a foreign firm's operations. Empirical studies have examined various aspects of knowledge transfer, including marketing know-how, distribution know-how, packaging product designs, process designs, purchasing know-how, and management systems and practices (Gupta & Govindarajan, 2000; Lee & MacMillan, 2008). Some of these measures are closely related to the establishment of supplier–manufacturer relationships. Therefore, we chose to measure knowledge transfer by using three items: (1) the information and know-how we have received from local suppliers contributes to the improvement of our product quality and product design (KT1); (2) the information and know-how we have received from local suppliers helps us to understand competitors' products and marketing strategies (KT2); and (3) the information and know-how we have received from local suppliers about our competitors' manufacturing techniques helps us to improve our product quality and product design (KT3).

Regulatory support: Regulatory support has to do with the extent to which local governments exercise favorable regulatory control over a firm (Luo, 2001; Park & Luo, 2001). Although regulatory support may be classified as occurring at either the regional level or national level (Luo, 2001), we chose to focus on the regional level because agglomeration is a location-specific phenomenon. Thus, this study measured regulatory support with the following two items: (1) compared to other regions, the local government in general illustrates more concern for our firm and provides us with more regulatory support (RS1); (2) compared to other regions, local government officials consider our needs more and provide us with more support (RS2).

Trust: Trust is an attribute of a relationship, according to which the relevant actors perceive that the other(s) is trustworthy and reliable (Tsai & Ghoshal, 1998). Lane et al. (2001) also noted that trust is learned and reinforced through on-going interactions, and highlighted the importance of a partner's overall confidence in the other's trustworthiness. Building on existing studies, this study measured trust along two dimensions: (1) we believe that our

Table 1
Final measurement model.

		Standardized factor loading	t-Value	Reliability
Financial performance	FP1	0.91	11.71***	0.95
	FP2	0.94	12.40***	
	FP3	0.95	12.67***	
Knowledge transfer	KT1	0.53	4.19***	0.84
	KT2	0.68	4.80***	
Regulatory support	RS1	0.87	7.46***	0.97
	RS2	0.80	7.04***	
Trust	TR1	0.78	8.70***	0.92
	TR2	0.83	9.28***	
Knowledge stock	KS1	0.87	10.01***	0.92
	KS2	0.85	9.72***	
Agglomeration	AG1	0.65	6.99***	0.89
	AG2	0.83	9.70***	
	AG3	0.92	11.24***	

** Significant at 0.05. * Significant at 0.10.
*** Significant at 0.01.

suppliers are trustworthy (TR1); and (2) we believe that our suppliers will keep their promises (TR2).

Knowledge stock: Knowledge stock has received much theoretical attention, and has been operationalized with a variety of measures, including patents (Lin, Lee, & Hung, 2006), entry modes, subsidiary size, and relative economic level across countries (Gupta & Govindarajan, 2000). We drew our measures from DeCarolis and Deed's (1999) study because this study has close conceptual links with our research. As suggested by DeCarolis and Deed (1999), knowledge stock represents the knowledge assets a foreign firm has accumulated over time, and which contribute to the development of new products. This construct was measured by asking participants to respond to two statements: (1) we can respond to market needs quickly by developing new products in the host country (KS1); and (2) we can convert new ideas into new products quickly in the host country (KS2).

Agglomeration: While empirical research has put forth several methods for measuring agglomeration, including the use of a dummy variable in which the presence of a firm's head office in a certain city yields a code of 1, or, if not, a code of 0 (e.g., Bell, 2005), or by calculating the proportion of industry establishments that are in the state in which a plant is located (e.g., Shaver & Flyer, 2000). These methods of measurement, however, tended to ignore one particular aspect which we believe to be an important attribute of firms within an agglomeration. Namely, a firm may diversify into several domains, or its products may involve components from several industries (Porter, 1998). Thus, the use of a simple industrial code cannot clearly identify potential suppliers, customers, or competitors. Following Appold (1995) and Porter (1998), agglomeration is an indication of the extent to which a foreign firm is located in geographical proximity to its competitors, customers, and suppliers. Therefore, we included three items in our measurement: (1) we and many competitors are located geographically close to one another in the same area (AG1); (2) we have clustered with many suppliers in the same area (AG2); and (3) we have collocated with many clients in the same area (AG3).

This study controls for several organizational factors in examining their impacts on endogenous variables. *Firm size* was often found to affect firm performance (e.g., Appold, 1995), as was regulatory support (Luo, 2001). Firm size was computed according to the number of employees within a firm. *Length of operation* was also found to be influential, owing to liabilities of newness (Luo, 2001). A firm with more experience in a host country may

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[5] Given both the limitations of data availability and the problems of accessing behavioral indicators, we employed perceptual measures. Significantly, however, Wright et al. (2005) also noted that problems regarding access to reliable archival data were evident in several studies conducting surveys in emerging economies. Thus, future studies may benefit by triangulating our findings with other objective measures.

Table 2
Correlation matrix and descriptive statistics ($N = 102$).

	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1. FP1	4.11	1.61	1.00																
2. FP2	4.33	1.65	0.86**	1.00															
3. FP3	4.16	1.66	0.85**	0.89**	1.00														
4. KT1	4.37	1.37	0.20*	0.29**	0.28**	1.00													
5. KT2	4.54	1.42	0.23*	0.31**	0.32**	0.73**	1.00												
6. RS1	4.10	1.71	0.20*	0.20*	0.27**	0.13	0.31**	1.00											
7. RS2	4.25	1.65	0.15	0.14	0.21*	0.15	0.30**	0.94**	1.00										
8. TR1	4.75	1.52	0.26**	0.20*	0.23*	0.21*	0.35**	0.33**	0.27**	1.00									
9. TR2	4.69	1.59	0.32**	0.27**	0.26**	0.20*	0.29**	0.31**	0.25*	0.84**	1.00								
10. KS1	5.09	1.52	0.21*	0.22*	0.26**	0.33**	0.36**	0.23*	0.23*	0.38**	0.34**	1.00							
11. KS2	4.99	1.51	0.23*	0.23*	0.23*	0.25*	0.32**	0.24*	0.22*	0.38**	0.33**	0.85**	1.00						
12. AG1	4.56	1.70	0.14	0.16	0.21*	0.34**	0.49**	0.15	0.14	0.19	0.11	0.25*	0.24*	1.00					
13. AG2	4.48	1.82	0.21*	0.21*	0.23*	0.42**	0.51**	0.15	0.13	0.21*	0.20*	0.29**	0.31**	0.88**	1.00				
14. AG3	4.23	1.86	0.21	0.15	0.20*	0.28**	0.30**	0.17	0.20*	0.12	0.00	0.24*	0.33	0.68**	0.67	1.00			
15. Size	3.15	1.48	−0.03	0.07	0.08	0.12	0.00	0.31**	0.30**	0.14	0.11	0.10	0.05	0.13	0.10	0.14	1.00		
16. Export	5.72	1.86	−0.22*	−0.12	−0.14	−0.13	−0.22*	0.15	0.24*	0.07	0.01	−0.02	0.01	−0.20*	−0.25*	−0.13	0.20*	1.00	
17. Length of operation	3.46	1.95	−0.20*	−0.07	−0.05	−0.06	0.02	−0.06	−0.08	0.00	0.03	−0.05	−0.04	0.15	0.05	0.06	0.15	−0.03	1.00

** Significant at 0.05.
* Significant at 0.10.

Table 3
Estimates of the hypothesized structural model.

Path/hypothesis	Estimates	Standardized estimates	t-Values
Trust → Knowledge transfer (H1)	0.14	0.18	1.84*
Knowledge stock → Knowledge transfer (H2)	0.15	0.18	1.67*
Agglomeration → Knowledge transfer (H3)	0.37	0.45	4.12***
Knowledge stock → Regulatory support (H4)	0.24	0.23	2.19**
Agglomeration → Regulatory support (H5)	0.06	0.06	0.57
Knowledge transfer → Financial performance (H6)	0.31	0.26	2.52**
Regulatory support → Financial performance (H7)	0.16	0.17	1.72*
Size → Financial performance	0.03	0.04	0.36
Export intensity → Financial performance	−0.13	−0.15	−1.49
Length of operation → Financial performance	−0.09	−0.10	−1.05
Size → Regulatory support	0.28	0.28	3.01***

*** Significant at 0.01.
** Significant at 0.05.
* Significant at 0.10.

demonstrate superior performance in that country. *Export intensity* may likewise indicate strong financial performance. We controlled for this effect by taking into account the proportion of export sales to total sales.

This study is based on self-reported data measured using a Likert scale, and therefore may bear the possibility of common method bias. Following Podsakoff and Organ's (1986) suggestion, Harman's single-factor test was used to test for common method variance. This technique assumes that "if a substantial amount of common method variance is present, either (a) a single factor will emerge from the factor analysis, or (b) one 'general' factor will account for the majority of the covariance in the independent and criterion variables" (Podsakoff & Organ, 1986, p. 536). We performed factor analysis on all items in the model. No general factor was apparent in the factor structure, indicating that the results do not have serious problems of common method variance.

Confirmatory factor analysis (CFA) was used to examine the adequacy of our measurement model (Jöreskog & Dag, 1989). Using CFA, we analyzed the factor loadings of the model. As a result, we chose to limit one of our measures (KT3) of knowledge transfer, by dropping the variable with factor loadings of less than 0.5. The removal of KT3 implies that the manufacturing techniques of local suppliers' other customers may be indirectly related to, inferior to, or be similar to a focal firm's product knowledge. Therefore, this measure does not significantly represent the same underlying construct, knowledge transfer. With this modification, the GFI of the measurement model increased to 0.89. We analyzed the factor loadings of the model shown in Table 1. The final measurement model provides a reasonable fit to the financial performance data, though the chi-square is statistically significant ($\chi^2_{(62)} = 87.19$, $p = 0.02$; GFI = 0.89, RMSEA = 0.064, NNFI = 0.95, PNFI = 0.61). In terms of the validity of the measures, convergent validity is evidenced by the significant loadings of the items on their posited constructs (Anderson & Gerbing, 1988, p. 416). Further, if the confidence interval of the correlation between any two latent constructs (as shown in the phi-matrix) excludes 1, it indicates that the measurement model has reached discriminant validity (Smith & Barclay, 1997). After checking the phi-matrix, we felt confident that our results provide acceptable discriminant validity. Additionally, when we assessed the reliability of our scales, the levels of Cronbach's α for all multi-item constructs exceeded the 0.80 level. Table 2 presents the descriptive statistics and inter-correlations for the variables in the analysis.

4. Results and discussion

4.1. Structural model analysis

This analysis was conducted via a structural model; the hypothesized relationships are presented in Table 3. Although the $\chi^2_{(96)} = 132.59$ ($p < 0.00$) is significant, other indicators suggest a reasonably good overall fit for the model (GFI = 0.87, RMSEA = 0.061, NNFI = 0.93, and PNFI = 0.63).

Trust and knowledge transfer from suppliers were positively correlated (t-value = 1.84, $p < 0.10$), as anticipated by H1. Knowledge stock proved likely to facilitate knowledge transfer (t-value = 1.67, $p < 0.10$), supporting H2. A significant and positive relationship was found between agglomeration and knowledge transfer (t-value = 4.12, $p < 0.01$), which is consistent with previous research (Tallman et al., 2004). Knowledge stock was likely to foster favorable regulatory support (t-value = 2.19, $p < 0.05$) H3 and H4 were both supported by the data. Surprisingly, the association between agglomeration and regulatory support did not emerge as significant (t-value = 0.57, $p > 0.10$); therefore, H5 was not supported. It might be the case that a firm's choice to locate in a particular region is not necessarily an indication of the local government's backing or privileged treatment of all of the firms within the agglomeration. As local governments pursue the maximization of tax revenues or economic growth, a single firm lacking unique knowledge stock will gain a lesser degree of support than will the other firms within an agglomeration. Therefore, agglomeration is not a salient factor in determining regulatory support.

With regard to the hypothesized relationships between the endogenous variables, knowledge transfer contributed by local suppliers was positively related to foreign firms' financial performance (t-value = 2.52, $p < 0.05$). Accordingly, H6 was supported. The relationship between regulatory support and financial performance was in fact positive and significant (t-value = 1.72, $p < 0.10$), consistent with H7. As for the control variables, we found that size showed a positive relationship to regulatory support (t-value = 3.01, $p < 0.01$).[6]

5. Conclusion

This article had two primary purposes. First, it presented an integrated framework within which to consider foreign firms' cooperation with local partners, including local suppliers and governments. Second, this study explored the determinants of knowledge transfer and regulatory support in China by incorporating the KBV and the legitimacy perspective. Trusting relationships and knowledge stock are related to moral and pragmatic interpartner legitimacy. Agglomeration, because it acts to generate cognitive legitimacy, helps to encourage the transfer of local suppliers' knowledge. Alternatively, regulatory support can be advanced, if foreign firms' business development is in line with local governments' interests. Such interests might include the accumulation of knowledge stock in the interest of creating a prosperous future and stimulating economic development.

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[6] In order to test the "mediated paths" of knowledge transfer and regulatory support, this study adopted Garbarino and Johnson's (1999) suggestion by comparing the hypothesized mediating model with a less parsimonious rival model without the mediator. In the rival model, all exogenous variables (i.e., trust, knowledge stock, agglomeration, size, export intensity, and length of operation) directly affected all of the endogenous variables (i.e., regulatory support, knowledge transfer, and financial performance). Further, we compared their fit via several features: (1) overall fit statistics, (2) percentage of significant paths, and (3) parsimony of the model, to decide whether the hypothesized mediating model was better or not. Our results showed that the hypothesized model (Fig. 1) is better on all measures. First, the hypothesized mediating model fits the data better (hypothesized model: $\chi^2_{(96)} = 132.59$ ($p < .00$); GFI = 0.87, RMSEA = 0.061, NNFI = 0.93, and PNFI = 0.63; nonmediational model: $\chi^2_{(87)} = 123.58$ ($p < .00$); GFI = 0.87, RMSEA = 0.065, NNFI = 0.93, and PNFI = 0.59). Second, a larger percentage of the paths are significant in the hypothesized mediating model versus the rival model (63.64% vs 20.00%). Third, the hypothesized mediating model is more parsimonious than the rival model (11 vs 20 paths). In addition, the overall fit statistics for the test of the nonmediational model did not show a significant improvement ($\Delta\chi^2 = 8.62$, $\Delta df = 9$). Taken altogether, the nonmediational model is rejected in favor of the hypothesized mediating model; that is, knowledge transfer and regulatory support mediate the effects of the three exogenous variables with respect to financial performance.

This study was motivated by our awareness of a theoretical gap. While the research derived from KBV has demonstrated that knowledge transfer requires the right set of circumstances with respect to both the knowledge transferor and the knowledge transferee, its hidden features and assumptions often go unnoticed when conducting research in mature market economies (Hoskisson et al., 2000). The unique social, political, and economic contexts of emerging economies (Wright et al., 2005) demand exploration of how foreign firms learn and adapt. Our most notable contributions to the institutional research arise from our explanation of how foreign firms can gain knowledge transfer from local suppliers and regulatory support from local governments.

6. Managerial relevance

This issue is not only important to the extension of theory; it also has several implications for managers. Understanding how to foster meaningful cooperation with local partners is among the central challenges for foreign firms operating in emerging economic regions. In particular, members of suppliers' networks, such as suppliers' clients, might be able to provide crucial information or knowledge to foreign firms (Lindstrand et al., 2009). Executives might look to our framework to address the issue of convincing local suppliers to supply them with knowledge. They might also look to our framework for insight into persuading local governments to provide regulatory support.

As indicated by our framework, while a firm level variable (i.e., knowledge stock) has been proven to have a crucial influence on the attainment of regulator support from local governments, top-level political authorities in China are likely to introduce a significant new tension. To help reform economic development, China's central government has delegated regulatory oversight to regional authorities (Ahlstrom et al., 2008). In fact, the officers in charge at different levels are even allowed to add more standards to the regulatory regime (Child & Tsai, 2005). Some of them can even interfere in the affairs of business. In such cases, to establish firm legitimacy, foreign firms should consider establishing relationships at different political levels (personal level, regional level, and national level) through different channels of guanxi. Nevertheless, guanxi can be a double-edge sword. It cannot be too heavily relied upon because of the rotation of officials (Ahlstrom et al., 2008). Further, the various levels of government authorities are likely to have competing and contradictory rules (Ahlstrom et al., 2008). One type of guanxi cannot satisfy the various interests among different government levels. Additionally, due to the differing interests of firms and governments, personal guanxi with governments may be inconsistent with the relationships of firms with governments (that is, the government guanxi may contradict with some of the interpersonal guanxi). Therefore, how to coordinate government authorities' and local partners' needs and values, as well as how to balance personal, regional, and national governmental relationships, along with firm interactions, should be a primary concern for foreign managers and deserve serious investigation.

7. Limitations

The implications of this study, however, should be evaluated in light of the following limitations. First, our empirical investigation places primary emphasis on the acquisition of legitimacy in terms of meeting the expectation of local suppliers and governments, rather than those of customers. While customers' perceptions are certainly important, taking into account customers' perceptions of legitimacy would limit our sample size by excluding manufacturers who primarily operate in global markets. If researchers are

able to expand the sample size in future studies, the inclusion of local customers' perceptions of legitimacy would enhance the contributions of our research framework. Second, while the nature of relationships with local suppliers and governments would seem to imply the existence of network ties, an alternative explanation having to do with the network perspective cannot be completely ignored. Our mediating variables are subject to different types of networks. Given the lack of network structural variables, and to reduce model complexity, we did not choose to use the network theory as our major theoretical background. Future research might wish to gather specific network structural variables to explore such research questions. Third, the generalizability of our results may be limited, because the impact of our key construct may be very different for foreign firms characterized by significant institutional differences from Chinese firms. Although Taiwan and China have largely developed independently in terms of political policies since 1949, Taiwan nevertheless shares many cultural traditions with China. This means that firms from these two societies have similar legitimacy-related challenges (Ahlstrom et al., 2008, p. 385); a common language and family network ties are likely to increase the legitimacy of Taiwanese firms operating business in China. Therefore, Taiwanese firms, compared with other foreign firms, may have accumulated the experience necessary to meet the legitimacy requirements embedded in China's business and political environment. Fourth, while research on strategy in emerging economies has greatly expanded in recent years, its applicability across countries has been uneven (Wright et al., 2005). For example, while China, India, and Brazil represent major emerging economies, their paths to the market and their culturally determined institutional environments differ greatly. Our findings, and even the framework we used, may be not equally applicable across different emerging economies. Cross-national studies should be conducted to assess the generalizability of our findings across varying institutional environments.

Based on this logic, we may incorporate the legitimacy perspective into the KBV and network perspective to identify a set of environments that calls for further study into gaining partners' support. Specifically, these environments can be segmented into six levels: international, national, regional, political, customer-oriented, and supplier-orientated. Each sub-environment level implies a different type of network tie (Ojala, 2009). In order to gain legitimacy within different levels, firms should, to some extent, actively adjust their behaviors to conform to the distinctive interests and values in host countries. Further, given that the nature of ties evolves with institutional change, a longitudinal research design may help to investigate the dynamic interactions between actors.

Acknowledgements

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