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Legitimacy Counts in Foreign Investments

WORKING PAPER 0612

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Abstract

Previous research suggests that a multinational firm faces a liability of foreignness in foreign investments. Establishing legitimacy, by aligning with the needs of the local environment or the internal organization, has been proposed as one way to reduce this liability. This research focuses on how legitimacy, both external and internal, relates to performance, and the moderating effects of business environment certainty. The results indicate that legitimacy counts in foreign investments.

Keywords: legitimacy, liability of foreignness, business environment, isomorphism

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Introduction

Much previous research has suggested that a multinational firm faces a liability of foreignness that will reduce its profits in foreign investments (Zaheer, 1995; Zaheer and Mosakowski, 1997). Establishing legitimacy in a local market has been proposed as one way to reduce this liability of foreignness (Kostova and Zaheer, 1999; Scott, 1995; Singh *et al.*, 1986). In addition, it has been suggested that a firm's organizational isomorphism, either aligning with the needs of its local environment or the needs of its internal organization may help the firm to establish legitimacy and may relate to its success (Rosenzweig and Nohria, 1994).

While the importance of legitimacy and isomorphism have been suggested previously as ways to reduce a firm's liability of foreignness, they have been empirically tested infrequently against firm profitability. This research attempts to bridge that gap to focus on how the external (environmental) and internal (organizational) legitimacy of a multinational firm relates to its operating margin, as moderated by the certainty or uncertainty of its business environment.

The results indicate that legitimacy counts in foreign investments. Companies benefit by building legitimacy externally with the local environment: establishing a strong brand image as well as a reputation for solid operating practices and strong customer service performance. Companies who build legitimacy internally with their employees also benefit from low turnover and employees recommending the firm as a place to work, supporting business decisions and choosing to continue working for the firm even if they can get a job with another organization in the industry. Firms who

understand how the different types of legitimacy interact with their business environment may be able to use this knowledge to reduce their liability of foreignness in foreign investments.

Theory Development

Liability of foreignness, legitimacy, business certainty and profitability

The assumption of a liability of foreignness is an important part of the theory of foreign direct investment and much of the theoretical and empirical attention has been directed at how multinational companies might compensate for this liability (Zaheer and Mosakowski, 1997). The liability of foreignness research draws primarily from early work on foreign direct investment by Hymer (1976) and Dunning (1988; 2000; 1980).

This liability of foreignness relates to increased costs for foreign firms that may come from four, not necessarily independent, sources: (1) costs directly associated with distance, such as the costs of travel, transportation and coordination; (2) costs based on a company's unfamiliarity with and lack of roots in a local environment; (3) costs resulting from the host country environment, such as the lack of legitimacy of foreign firms and economic nationalism; and (4) costs from the home country environment, such as the restrictions on high-technology sales to certain countries imposed on US-owned MNEs (Zaheer, 1995; Zaheer and Mosakowski, 1997). In addition, the host country may be unfamiliar with the foreign entrant and employ higher legitimacy standards for the foreign firm (Kostova and Zaheer, 1999).

In their study of foreign vs. local currency trading rooms, Zaheer and Mosakowski (1997: p. 457) concluded,

These results suggest that noneconomic factors such as networks (Baker, 1984), the extent of local embeddedness (Granovetter, 1985), institutional linkages (Baum and Oliver, 1991) and organizational legitimacy in the local environment (Scott, 1995) may matter even in for-profit firms operating in very competitive markets.

In certain situations it may be that foreignness can be an asset instead of a liability. For example, Miller and Parkhe (2002) found evidence of both an asset and a liability of foreignness in the global banking industry, depending on the match between the home and host country environments. For example, U.S.-owned banks had a competitive advantage, or an “asset of foreignness”, in host countries with bank-oriented financial systems as compared to foreign-owned banks. In contrast, they were less competitive than foreign-owned banks in host countries with high credit risk and capital market-oriented financial systems. [Newburry *et al.* \(2006\)](#) suggested that in [developing countries, where local companies may have limited skills and primarily local networks, foreignness may be an advantage because of better working conditions and greater access to technology, international networks and large overseas markets.](#)

As identified by Kostova (1999) and Zaheer and Mosakowski (1997), organizational legitimacy may be one factor related to a firm’s liability of foreignness. Legitimacy has been described as the acceptance of an organization by its external environment (Deephouse, 1996; DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Meyer and Scott, 1983; Zimmerman and Zeitz, 2002), the extent to which a

new form conforms to recognized principles or accepted rules and standards (Aldrich and Fiol, 1994) and the extent to which a firm pursues socially acceptable goals in a socially acceptable manner (Ashforth and Gibbs, 1996). It has been suggested that legitimacy may not be purchased. It must be granted to an organization by the other actors in the environment, for example by government regulators, the state, the financial community, the media or public opinion (Deephouse, 1996; Hybels, 1995).

Organizations need legitimacy in order to acquire other resources such as top managers, quality employees, financial resources, technology and government support (Zimmerman and Zeitz, 2002). As well, acquiring local legitimacy is a critical step in overcoming the liability of foreignness and is also important in overcoming the “liability of newness”. When starting a new business or line of activity, especially one with few precedents elsewhere, organizations face the task of winning acceptance for the business (Suchman, 1995).

While the general dimensions of legitimacy are consistent across studies, it is important to note that the critical “grantors” and indicators of legitimacy vary by industry, and an organization can only gain legitimacy from some source(s), based on its adopted practices (D'Aunno *et al.*, 1991). For example, in the banking industry, government and regulatory agencies grant legitimacy, and indicators may be related to fulfilling capital requirements. In the fast-moving consumer goods industry, consumers are important grantors of legitimacy and advertising presence may be one legitimacy measure. Furthermore, in some industries a particular kind of legitimacy may be simply required to be in business. As described above, banking is one such

industry as is the inspection/certification business, where upholding government regulations is a requirement for doing business. In such industries, legitimacy may depend more on actors' trust in the legal infrastructure than it does on upholding regulations.

Previous research has identified an important relationship between legitimacy and a firm's liability of foreignness. Liability of foreignness theory suggests that a foreign firm will be less profitable than a domestic firm, partly because it has lower legitimacy in the local environment. A foreign firm that can establish local legitimacy may be able to reduce its liability of foreignness and enhance its performance suggesting that there will be a positive relationship between legitimacy and profitability.

Hypothesis 1: There is a direct positive relationship between a firm's legitimacy and profitability such that higher legitimacy correlates to higher profitability.

Previous research has shown that a firm's business environment has a relationship with its performance, both in terms of its organizational structure and its financial requirements to compensate for risk. In their research on contingency theory, Lawrence and Lorsch (1967/1986) found that a firm's organizational structure was positively related to its performance when it positioned the company to respond to the conditions in the external environment. More specifically, they found an important relationship among the external variables (the certainty and diversity of the

environment and the strategic environmental issue), the internal states of differentiation and integration and the process of conflict resolution. If an organization's internal states and processes were consistent with external demands, it would be effective in dealing with its environment.

The profitability of a multinational firm may also be related to the certainty of the country business environment in which it operates. Finance theory suggests that a firm will demand higher levels of return in uncertain business environments as a premium to compensate for the additional risk undertaken by the business, called the "risk / return tradeoff" (Brealey and Myers, 2000). This suggests that for a multinational firm, profitability will also be related to the certainty or uncertainty of the business environment.

Hypothesis 2: The firm will require a risk / return tradeoff such that in less certain business environments, operating margin will be higher and in more certain business environments, operating margin will be lower. Specifically, there will be a negative correlation between business certainty and operating margin.

It is important for a firm to understand what factors relate to its establishing legitimacy, relative to its business context. For example, Goodrick and Salancik (1996) suggested that organizational influence on practice will be greatest when institutional standards are most uncertain, with organizational interests having the most effect at intermediate levels of risk, when institutional uncertainty is most

present. Kostova (1999) suggested that the larger the institutional distance between the home and host countries, the more difficult it was for the MNE to establish legitimacy in the host country and to transfer strategic routines to foreign subsidiaries. Finally, Xu *et al.* (2002) suggested that a large institutional distance triggers the conflicting demands for external legitimacy (or local responsiveness) in the host country and internal consistency (or global integration) within the MNE system and that an organization can gain legitimacy only from some sources, and that its discretion in adopting different practices is influenced by such contextual variables as uncertainty (Xu *et al.*, 2004).

The research described above suggests that a multinational firm with its headquarters in a more certain business environment faces a liability of foreignness which is greater in uncertain business environments and translates into lower legitimacy and lower profits on average. Properly managed, however, legitimacy may increase profits and may help to create an “asset of foreignness” as was illustrated by Miller and Parkhe (2002). This leads to hypothesis 3 suggesting a moderating relationship between legitimacy, business certainty and profitability.

Hypothesis 3: Business environment certainty will moderate the relationship between legitimacy and profitability such that legitimacy has a stronger relationship with profitability in uncertain as compared to certain business environments.

Business certainty and isomorphism

To achieve legitimacy, organizations must conform to the norms set by the firm's institutional environment, both the local market's institutional environment and the internal environment of the parent and subsidiaries (Davis *et al.*, 2000; Haveman, 1993; Kostova and Zaheer, 1999). Imitation comes about because prior decisions or actions by other organizations increase the legitimacy of similar decisions and actions, something particularly important in the face of high uncertainty (DiMaggio and Powell, 1983; Lu, 2002). Consequently, institutional isomorphism, both structural and procedural, has been suggested as a way to earn the organization legitimacy (Deephouse, 1996; Suchman, 1995).

Isomorphism is defined as the pressure that forces one unit in a population to resemble other units that face the same set of environmental conditions (DiMaggio and Powell, 1983: 149). Within an MNE, this creates competing demands – one for isomorphism with local firms in the host country, the other for isomorphism with other units within the MNE or in the home country (Bartlett and Ghoshal, 1989; Prahalad and Doz, 1987). Rosenzweig and Nohria (1994) identified the same dual pressures for local adaptation and internal consistency in Human Resources Management (HRM) practices. Important factors relating to isomorphism were the presence of expatriates and the cultural distance, both of which had a significant negative relationship with isomorphism. They further suggested that the resemblance to local HRM practices is negatively related to the extent to which the affiliate operates in a global vs. multi-domestic industry, however, this element was not found to be significant in their results.

Given that the search for isomorphism places conflicting demands on the MNE for gaining external and internal legitimacy, it has been suggested that the MNE will cater to external demands for isomorphism with local institutions first at the expense of some internal demands for consistency within the MNE system. Xu *et al.* (2004: 288) found that the “larger the distances between the host and home countries the more difficult it was for the MNE . . . to transfer organizational practices from the parent firm to the foreign subsidiary.” They also suggested that a local orientation (or external legitimacy) exerts a stronger influence on the MNE than internal consistency (or internal legitimacy). This leads to Hypothesis 4.

Hypothesis 4: In uncertain business environments, there is significant correlation between Business Certainty and External Legitimacy and a non significant correlation between Business Certainty and Internal Legitimacy, reflecting the priority of establishing external legitimacy over internal legitimacy.

Business certainty, isomorphism, and performance

Previous international business research has emphasized the effects of liability of foreignness (Zaheer, 1995; Zaheer and Mosakowski, 1997), legitimacy (Kostova and Zaheer, 1999; Scott, 1995), local isomorphism (Rosenzweig and Nohria, 1994), and institutional distance (Kostova, 1996) on firm survival and success (Xu *et al.*, 2004; Xu and Shenkar, 2002). This suggests that there is an interaction effect between a firm’s internal and external legitimacy and the certainty of its business environment

that is related to its performance. Specifically, in more uncertain business environments, or those with greater institutional distance from a multinational firm based in a certain environment, external legitimacy as compared to internal legitimacy will be related more strongly with operating performance.

Hypothesis 5: The priority of establishing external legitimacy over internal legitimacy will relate to a firm's operating margin. Specifically, the moderating relationship of business certainty between external legitimacy and operating margin will be significant. The moderating relationship of business certainty between internal legitimacy and operating margin will not be significant.

Methodology

The hypotheses were tested by comparing 54 country business units (CBUs) in two divisions of a single multinational firm. The data for internal and external legitimacy were collected using a structured interview questionnaire with senior managers in each country business unit. Business environment certainty was measured using an index developed from an international database. The dependent variable of performance, specifically operating margin, was taken from company sources.

Company

The company, referred to here as ServCo, provides professional services related to value-chain management, operating in 120 countries around the world with 42,000 employees. Different divisions of the company focus on widely varying services.

This research focused on two divisions. The first provides global logistics support and, as the founding division of the company, has been in business for over a century. The second provides local consulting services and was the result of a recent decision to diversify the business portfolio; it has been in business about 10 years. Business units in 42 countries were studied, with some countries having business units from both divisions. A total of 54 CBUs are represented, with 20 in Global Logistics and 34 in Local Consulting. Using this sample we could assess industry differences while holding company variables, such as company culture, constant.

Interviews

Legitimacy data were collected during structured interviews of the top management team of each country business unit. The survey was limited to the CBU senior management team because previous research suggests that the characteristics of the top management team are highly predictive of a wide array of organizational outcomes and are substantially more predictive than characteristics of CEOs alone (Finkelstein and Hambrick, 1990; Smith *et al.*, 1994).

In total, 101 structured interviews were completed with these senior country managers. This was an 84% response rate of the total sample provided by the company. Each structured interview lasted approximately 30-45 minutes and was done on the telephone. Telephone interviews were more efficient than face-to-face interviews given the number of countries involved.

Operationalization of Variables

Business environment certainty

To measure the certainty of the business environment, a Business Certainty Index was created according to techniques and guidelines presented in other studies (Fisher, 1998; Husted, 1994; Inglehart and Baker, 2000; Kadushin, 2002; Lawrence and Lorsch, 1967/1986; Uzzi, 1997; Wan and Hoskisson, 2003). The index represents the certainty and degree of trust in a country's institutional environment, important factors for a firm and its risk of doing business in a specific country.

Following an approach similar to that of Xu *et al.* (2004), twenty-five items were selected from the The Global Competitiveness Report for inclusion in the index that measured either certainty or trust. The 25 items are listed in Figure 1.

Insert Figure 1 About Here

Data from all 80 countries in The Global Competitiveness Report on each of these items was analyzed using a Principal Components Analysis with Varimax Rotation and Kaiser Normalization. The initial analysis produced 4 components that explained 80% of the variance. A second iteration was performed, eliminating 6 items: extent of bureaucratic red tape, efficiency of the tax system, freedom of the press, inflation, recession expectations and business costs of terrorism. Another factor analysis was performed on the remaining items, identifying 2 factors that explained 81% of the variance. A final iteration eliminated one more item, GDP/Capita, resulting in all items consolidating into one "certainty" factor that explained 77% of

the variance. The final 18 items and their component coefficient scores are listed in Table 1.

Insert Table 1 About Here

The country's score for each of the items listed above was averaged to create the business certainty index for each country. All item scores were directionally similar, i.e. 1 was uncertain and 7 was certain. In addition, two countries included in the study, Egypt and Saudi Arabia, were not included in The Global Competitiveness Report but were included in a separate report by the same organization entitled The Arab World Competitiveness Report (World Economic Forum, 2003). In this report, only 9 of the 18 items selected for the business certainty index were published. For Egypt and Saudi Arabia, the certainty index was calculated as the average of these 9 items: organized crime, reliability of police services, effectiveness of antitrust policy, intensity of local competition, business costs of corruption, favoritism of government officials, judicial independence, distortive government subsidies and soundness of banks.

The mean certainty score for the 82 countries was 4.093. The final business certainty index scores for all countries are listed in Appendix A.

Legitimacy scale

To determine the legitimacy of a country business unit as perceived by the respondent in his/her country, a legitimacy scale was constructed, based on the approach of Elsbach (1994). The legitimacy section of the research questionnaire included the 12 items used by Elsbach to measure legitimacy in her study of the California cattle industry. The ServCo executive vice presidents added two questions to measure client perception of operating procedures and customer service performance, additional areas they believed would relate to legitimacy in their businesses.

As with the approach of Elsbach, the ServCo respondent answers were analyzed using Principal Components Analysis with Varimax Rotation and Kaiser Normalization. Elsbach originally found that her 12 questions grouped into three factors that she called prescriptive normativity (attributes that a legitimate organization should have), internal endorsement (support by employees) and external endorsement (support by the general public). An exploratory factor analysis in this study also identified three factors, though these factors differed somewhat from those found by Elsbach. Eleven items loaded on to three factors that were named Internal Endorsement (support by employees), External Endorsement – Business Practices (support by customers and the general business community) and External Endorsement – Image (perception of the company in the marketplace).

The prescriptive normativity factor that Elsbach identified was not significant in this study, perhaps due to the nature of the industry. In this industry, “following the rules” is a requirement of doing business, not a measure of legitimacy. In fact, when the EVPs reviewed the questionnaire during its development, they consistently asked why questions were included such as “ServCo follows government regulations that apply to it.” They said, “Our business is to make sure that other companies follow regulations. How can we be in business if we don’t?”

The final factor loadings are listed below in Table 2. A confirmatory factor analysis using AMOS validated this three-factor structure.

Insert Table 2 About Here

Each respondent’s answers for the items in the factor (Internal Endorsement, External Endorsement – Business Practices, External Endorsement - Image) were averaged to construct the factor legitimacy scores. An overall legitimacy score for each individual was calculated as the average of the three legitimacy factor scores. For each country business unit, each respondent’s factor and overall legitimacy scores were averaged to create the country business unit legitimacy scores, including an external legitimacy score that was the average of the two external legitimacy factors.

Performance

Performance was defined as the operating margin at the CBU level of analysis for the financial year that ended six months prior to data collection. Relative operating

margins of CBUs tended to be stable over time (Company Source), so this was the most appropriate and accessible measure of performance. Of course, with this cross-sectional approach we cannot rule out alternative causes of performance.

Control Variables

We included two control variables that are not related to our theory-testing but have been shown to be related to our variables in systematic ways: a dummy variable to differentiate the two divisions and the natural logarithm of the CBU sales revenue for the most recent financial year.

Results

Legitimacy, business certainty and performance

Table 3 shows the mean, standard deviation and correlations between the primary variables in this research.

Insert Table 3 About Here

There is a strong positive correlation between operating margin and all of the legitimacy variables, supporting Hypothesis 1. This suggests that legitimacy may reduce a firm's liability of foreignness and enhance its performance. There is also a strong negative correlation between business certainty and operating margin, supporting the risk / return tradeoff suggested by Hypothesis 2 such that less certain business environments are associated with higher operating margin while more certain business environments are associated with lower operating margin. These correlation

results and the cross-sectional nature of this research, however, do not allow for a determination of the causal direction of the relationships.

Business certainty as a moderator between legitimacy and profitability

Hypothesis 3 suggests that business certainty will moderate the relationship between legitimacy and profitability. This was tested using a moderated regression analysis based on the approach of Baron and Kenny (1986). Following their approach, a hierarchical regression analysis was done with legitimacy as the predictor variable, business certainty as the moderator variable, and operating margin as the dependent variable. The interaction variable was calculated by multiplying legitimacy x business certainty and this variable is significant as shown in Table 4. Consequently this hypothesis is supported.

Insert Table 4 About Here

Business certainty and external / internal legitimacy

Hypothesis 4 suggests that there will be a relationship between business certainty and isomorphism such that in uncertain business environments, the relationship between business certainty and external legitimacy will be stronger than the relationship between business certainty and internal legitimacy, reflecting the priority of establishing external legitimacy over internal legitimacy. These relationships may vary by industry type, such that external legitimacy is more important in multi-domestic industries, while internal legitimacy is more important in global industries.

Looking again at the correlation analysis in Table 3, the relationship between business certainty and external legitimacy is $r=-.369$ ($p>.01$) while the relationship between business certainty and internal legitimacy is $r=-.258$ ($p>.10$). The negative direction of this relationship suggests that in more certain business environments, ServCo has lower legitimacy while in less certain business environments, the firm has greater legitimacy. This suggests an asset of foreignness for ServCo in uncertain business environments. The relationship of business certainty is stronger with external legitimacy than with internal legitimacy, supporting Hypothesis 4.

Insert Table 5 About Here

Business certainty, isomorphism and performance

Hypothesis 5 suggests that the business certainty of the country environment will moderate the relationship between external legitimacy and operating margin while there will be no moderating relationship between internal legitimacy and operating margin. To test this, we performed two separate moderated regression analyses, the first testing the moderating relationship of business certainty between external legitimacy and performance and the second testing the moderating relationship of business certainty between internal legitimacy and performance. These results are shown in Table 6.

Insert Table 6 About Here

The results suggest that, contrary to our hypothesis, internal legitimacy has a significant relationship with business performance moderated by environmental certainty while external legitimacy has an insignificant relationship with business performance moderated by environmental certainty. In the final regression step in the external legitimacy hierarchical regression, none of the variables are significantly related to performance: external legitimacy, business certainty or the interaction term. In contrast, in the hierarchical regression with internal legitimacy, all the variables are related significantly to performance: internal legitimacy, business certainty and the interaction term.

Since previous research suggests that there may be a difference in isomorphism between global and multi-domestic industries (Rosenzweig and Nohria, 1994), we repeated the hierarchical regression for the two divisions individually. In Global Logistics, the moderating effect of business certainty between legitimacy and performance is not supported for either internal or external legitimacy as neither interaction term is significant. In Local Consulting, there is a significant moderating effect of business certainty on external legitimacy where all three variables are related significantly to operating performance: external legitimacy, business certainty and the interaction term. Relative to internal legitimacy, business certainty does not moderate the relationship with performance. Hypothesis 5 is supported in Local Consulting.

Discussion

The results show support for the relationship between legitimacy and performance such that legitimacy is related to the performance of a multinational firm and may

reduce the firm's liability of foreignness. In addition, the results support a risk / return tradeoff such that the firm demands higher returns as the tradeoff for the higher risk of operating in a more uncertain business environment. Relative to the interaction of these variables: legitimacy, business certainty and performance, the results show general support for our hypotheses as well as some interesting new findings.

The results show that business certainty is an important moderating variable between legitimacy and performance supporting our hypothesis that for a multinational firm headquartered in a more certain business environment, legitimacy will be especially valuable in reducing the firm's liability of foreignness and improving performance in more uncertain business environments where there is a great institutional distance for the firm.

Breaking down the components of legitimacy into internal and external and looking at how internal vs. external legitimacy relates to business certainty and performance shows interesting results. Our hypothesis that external legitimacy is more important than internal legitimacy in uncertain business environments is supported. There is a stronger and more significant correlation between external legitimacy and business certainty than between internal legitimacy and business certainty. This correlation is negative, reflecting the fact that in more uncertain business environments, legitimacy of either type is more important, suggesting an asset of foreignness for this multinational firm in uncertain business environments.

The proposed moderating relationship of business certainty between external legitimacy and performance is supported only in Local Consulting. In both divisions combined, there is a significant moderating relationship of business certainty between internal legitimacy and performance, and there is no significant moderating relationship of either type of legitimacy in Global Logistics. These results may be related to their time in business / existing liability of foreignness as suggested by Zaheer and Mosakowski (1997) who found that the peak of a firm's liability of foreignness for global trading rooms was at 9 years and after 16 years, a firm's liability of foreignness effectively disappeared. Local Consulting has been in existence for 10 years, just past its liability of foreignness peak, and Global Logistics was the founding division of the company and has been in business for 125 years, so it may no longer have a liability of foreignness. Our results in Local Consulting support the hypothesis that external legitimacy is more important in uncertain business environments and that business certainty plays a moderating role in the relationship between external legitimacy and performance. It appears that legitimacy no longer plays a role relative to performance in Global Logistics where a liability of foreignness may no longer be a factor.

The difference in the results may also be related to the global vs. multi-domestic nature of the two business units: Global Logistics is a global industry while Local Consulting is a multi-domestic industry. There are differences in the correlations with Business Certainty in the two divisions. External legitimacy is highly significant in Global Logistics while internal legitimacy is not significant as shown in Table 5. In contrast, both internal and external legitimacy are significant in

Local Consulting. These results do not, however, support the previous proposition by Rosenzweig and Nohria (1994) that internal legitimacy is more important in global industries while external legitimacy is more important in multi-domestic industries.

Interestingly, when the two divisions are combined, internal legitimacy becomes important and business certainty plays a moderating role in the relationship between internal legitimacy and performance. Internal legitimacy has the strongest correlation with performance in the two divisions combined and the relationship between legitimacy and business certainty is negative, suggesting that legitimacy is more important in uncertain business environments. [It may be that in uncertain business environments, employees are particularly proud to work for a foreign multinational company that supports its employees and maintains high operating standards such that working for a foreign company is prestigious as was suggested by Newburry *et al.* \(2006\).](#) In contrast, in more certain business environments many companies may support their employees and maintain high operating standards, which may result in less variance in internal legitimacy across firms competing for talent. This reinforces the idea of an asset of foreignness for this multinational company.

Limitations and Future Research

While the research makes several contributions to knowledge, like all studies its limitations constrain our ability to draw conclusions and generalize. The fact that the research was tested in just one company is one important limitation of this study. Although this in-depth focus on one company allowed us to build relationships and obtain sensitive data on legitimacy and performance, it limits the generalizability of

the study. Second, the legitimacy data was gathered based solely on the CBU senior manager's perceptions of the company's internal and external legitimacy. While these perceptions were gathered based on a previously tested method, there still may be measurement error in the results. Finally, the cross-sectional rather than longitudinal research design and analysis allows us to identify relationships between variables, but it does not allow us to conclude a causal relationship between our key variables and performance.

Future research offers the opportunity to build on these limitations and explore the relationship between different types of legitimacy and performance in foreign investments in greater depth. This future research may focus on understanding the different types of legitimacy, internal vs. external, and their role in specific situations. It may also focus on understanding industry and time differences related to legitimacy and performance. For example, this study focused on a company operating in a service industry. It would be useful to study different industry types: i.e. manufacturing vs. service or global vs. multi-domestic, including those where the prescriptive normativity factor identified by Elsbach is not a requirement of doing business as in this study. In addition, it would be interesting to learn more about the relationship between the length of time in business relative to a firm's liability of foreignness to understand how this relates to the relationship between legitimacy, business certainty, and performance.

Managerial Implications

For managers, the research implications suggest that legitimacy plays an important role in reducing a firm's liability of foreignness and improving its performance.

Understanding that there are different types of legitimacy, i.e. internal vs. external, and the roles each plays in the relationship with performance, may be helpful for managers establishing a business in a foreign country, particularly in the early years of the business. The important role of external legitimacy suggests that managers should try to establish external endorsement for the business by establishing solid operating practices and strong customer service performance. The company should establish its image locally by working with local business writers and establishing a strong brand through advertising, public relations or other promotion efforts. In the early years of a company, external legitimacy plays an important role with performance, especially in uncertain business environments or those most distant from the firm's home institutional environment.

The results also suggest that internal legitimacy plays an important role for a multinational firm relative to its performance. Internal legitimacy is characterized by employee support including recommending the firm as a place to work, low employee turnover, supporting business decisions and employees who would continue working for the firm even if they could get a job with another organization in the industry. The results suggest that internal legitimacy has a positive relationship with business performance that is not moderated by business certainty. Internal legitimacy is an important asset for multinational companies irrespective of the business environment where it operates.

Conclusion

A liability of foreignness may relate to a multinational firm's performance in its foreign investments and establishing legitimacy has been suggested as one way to reduce this liability. This research supports the importance of establishing legitimacy and its positive relationship with a firm's performance. In addition, different types of legitimacy, external and internal, may be more or less important depending on the certainty of the business environment where the firm operates. These results can help managers better understand how the different types of legitimacy can help them to reduce their liability of foreignness and improve their performance in foreign investments. The results show that legitimacy counts in foreign investments.

Appendix A

Business Certainty Index Scores by Country

Country	Business Certainty Index	Country	Business Certainty Index
Argentina	2.6	Latvia	3.8
Australia	5.5	Lithuania	3.7
Austria	5.4	Malaysia	4.6
Bangladesh	2.9	Mauritius	4.2
Belgium	4.8	Mexico	3.3
Bolivia	2.8	Morocco	4.1
Botswana	4.6	Namibia	4.3
Brazil	4.0	Netherlands	5.3
Bulgaria	3.1	New Zealand	5.5
Canada	5.3	Nicaragua	2.8
Chile	4.8	Nigeria	3.0
China	4.3	Norway	5.1
Colombia	3.3	Panama	3.6
Costa Rica	3.8	Paraguay	2.8
Croatia	3.4	Peru	3.4
Czech Republic	3.8	Philippines	3.2
Denmark	5.7	Poland	3.5
Dom Rep	3.6	Portugal	4.7
Ecuador	2.4	Romania	2.9
Egypt	4.5	Russia	3.0
El Salvador	3.6	Saudi Arabia	4.2
Estonia	4.5	Singapore	5.8
Finland	6.0	Slovak Republic	3.4
France	4.4	Slovenia	4.5
Germany	5.1	South Africa	4.4
Greece	4.1	Spain	4.5
Guatemala	2.4	Sri Lanka	4.3
Haiti	2.4	Sweden	5.1
Honduras	2.7	Switzerland	5.4
Hong Kong	5.4	Taiwan	4.6
Hungary	4.5	Thailand	4.2
Iceland	5.6	Trinidad	4.0
India	4.1	Tunisia	5.0
Indonesia	2.8	Turkey	3.5
Ireland	5.0	Ukraine	2.7
Israel	5.3	United Kingdom	5.6
Italy	4.2	United States	5.4
Jamaica	3.6	Uruguay	4.1
Japan	4.1	Venezuela	2.5
Jordan	4.3	Vietnam	3.6
Korea	4.4	Zimbabwe	2.9
Average Business Certainty Index Score		4.093	

Figure 1

Initial Items in Business Certainty Factor Analysis

<p>Aggregate Country Performance Indicators</p> <ul style="list-style-type: none"> • GDP Per Capita 	<p>Public Institutions – Corruption</p> <ul style="list-style-type: none"> • Business costs of corruption • Public trust of politicians
<p>Macroeconomic Environment</p> <ul style="list-style-type: none"> • Recession expectations • Soundness of banks • Business costs of terrorism • Extent of distortive government subsidies • Inflation (2001) 	<p>Public Institutions – Contracts and Law</p> <ul style="list-style-type: none"> • Judicial independence • Efficiency of legal framework • Property rights • Freedom of the press • Burden of regulation • Transparency of government policy-making
<p>Domestic Competition</p> <ul style="list-style-type: none"> • Intensity of local competition • Effectiveness of antitrust policy 	<ul style="list-style-type: none"> • Favoritism in decisions of government officials • Extent of bureaucratic red tape • Effectiveness of law-making bodies • Efficiency of the tax system • Reliability of police services • Business costs of crime and violence • Organized crime • Strength of auditing and accounting standards
<p>Company Operations and Strategy</p> <ul style="list-style-type: none"> • Ethical Behavior of firms 	

Table 1
Final Items in Business Certainty Factor

Item	Component Score
Efficiency of legal framework	0.965
Property rights	0.945
Favoritism in decisions of government officials	0.940
Ethical behavior of firms	0.936
Transparency of government policy-making	0.932
Judicial independence	0.928
Reliability of police services	0.920
Business costs of corruption	0.918
Effectiveness of law-making bodies	0.913
Public trust of politicians	0.885
Strength of accounting and auditing standards	0.884
Organized crime	0.857
Effectiveness of antitrust policy	0.857
Business costs of crime and violence	0.846
Soundness of banks	0.777
Intensity of local competition	0.770
Extent of distortive government subsidies	0.753
Burden of regulation	0.733
 Cronbach α	 .982

Table 2
Legitimacy Factor Analysis Results

	Factor 1: Internal Endorsement (IE)	Factor 2: External Endorsement - Business Practices (EE- BP)	Factor 3: External Endorsement – Image (EE-I)
Employees Recommend to friends as a place to work	.790	.175	.200
Employee Turnover: one of the lowest rates in the industry	.733	.283	-.091
Local Employees fully support business decisions	.713	.207	.273
Continue Working for even if could get a job with another organization in the industry	.687	.131	.480
Operating Practices: clients approve	.218	.856	.231
Market Operating Procedures: market approves	.154	.836	.102
Customer Service Performance: clients approve	.262	.696	.220
Local Business Community approves	.187	.674	.256
Business Writers view as one of the top firms in the industry	.067	.213	.853
Strong Brand: viewed as a strong brand in country	.232	.240	.776
Industry Standards: concerned with meeting industry standards	.425	.355	.531
Number of items included in factor	4	4	3
Cronbach α	.80	.84	.76

Table 2**Legitimacy Confirmatory Factor Analysis**

Fit Measure	Default Model
P	0.0169
Discrepancy /df	1.208
Incremental fit index	0.981
Tucker-Lewis index	0.974
Comparative fit index (CFI)	0.980
RMSEA	0.046
RMSEA lower bound	0.000
RMSEA upper bound	0.086
P for test of close fit	0.534
Expected cross validation index	0.995

Table 3
Correlations

	Mean	Min	Max	Std. Deviation	Operating margin	Business Certainty	Internal Legit	EL - BP	EL - Image	External Leg Avg	Legit Average	Division Dummy
Operating Margin	0.158	(0.300)	0.415	0.123								
Business Certainty	4.321	2.400	5.800	0.918	-0.270+							
Internal Legitimacy	5.181	1.750	6.750	0.944	0.388**	-0.258+						
External Legitimacy- Business Practices	5.704	2.500	7.000	0.699	0.274*	-0.287*	0.619**					
External Legitimacy - Image	5.904	1.333	7.000	0.975	0.285*	-0.384**	0.594**	0.725**				
External Legitimacy Avg	5.804	1.920	7.000	0.779	0.301*	-0.369**	0.649**	0.902**	0.951**			
Legitimacy Average	5.596	1.861	6.639	0.762	0.365**	-0.357**	0.855*	0.870**	0.893**	0.949**		
Division Dummy	0.630	0	1	0.487	0.059	0.034	-0.059	-0.110	-0.415**	-0.309*	-0.235+	
LN Revenue	8.169	5.855	10.924	1.165	0.030	0.386**	-0.003	-0.011	0.012	0.003	0.000	-0.119

** p ≤ .01

* p ≤ .05

+ p ≤ .10



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Table 4

Moderation of Business Certainty Between Legitimacy and Operating Margin

Model	R ²	Chg in R ²	Adj R ²	Sig Adj R ²	Variables entered	β	T	Sig
All CBUs (N=54)								
1	.002		-.018	.759	(Constant)		5.325	.000
					Division Dummy	.043	.309	.759
2	.160	.158	.126	.013	(Constant)		-1.360	.180
					Division Dummy	.152	1.088	.282
					Legitimacy	.352	2.518	.015
3	.179	.019	.129	.021	(Constant)		-.125	.901
					Division Dummy	.137	.981	.331
					Legitimacy	.285	1.894	.064
					Business Certainty	-.170	-1.188	.241
4	.255	.076	.193	.006	(Constant)		-1.458	.151
					Division Dummy	.171	1.217	.229
					Legitimacy	1.372	1.827	.074
					Business Certainty	1.409	1.306	.198
					Legitimacy x Bus Certainty	-1.558	-1.477	.146

** p ≤ .01

* p ≤ .05

+ p ≤ .10

Table 5

Correlations: Business Certainty, Legitimacy, and Operating Margin

Correlation with Business Certainty

	All CBUs	Global Logistics	Local Consulting
Internal Legitimacy	-0.258+	-0.180	-0.304+
External Legitimacy	-0.369**	-0.577**	-0.354*
Legitimacy Average	-0.357**	-0.568*	-0.353*

Correlation with Operating Margin

	All CBUs	Global Logistics	Local Consulting
Internal Legitimacy	0.388**	0.324	0.501**
External Legitimacy	0.301*	0.172	0.494**
Legitimacy Average	0.365*	0.347	0.523**
Business Certainty	-0.270+	-0.426+	-0.117

Table 6
Moderation of Business Certainty Between Internal and External Legitimacy
and Operating Margin

Model	R ²	Chg in R ²	Adj R ²	Sig Adj R ²	Variables entered	β	T	Sig
External Legitimacy								
1	.002		-.018	.759	(Constant)		5.325	.000
					Division Dummy	.043	.309	.759
2	.114	.112	.079	.048	(Constant)		-1.360	.180
					Division Dummy	.152	1.088	.282
					External Legitimacy	.352	2.518	.015
3	.139	.025	.086	.060	(Constant)		-.125	.901
					Division Dummy	.137	.981	.331
					External Legitimacy	.285	1.894	.064
					Business Certainty	-.170	-1.188	.241
4	.176	.037	.108	.050	(Constant)		-1.458	.151
					Division Dummy	.171	1.217	.229
					External Legitimacy	1.372	1.827	.074
					Business Certainty	1.409	1.306	.198
					External Legitimacy x Business Certainty	-1.558	-1.477	.146
Internal Legitimacy								
1	.002		-.018	.759	(Constant)		5.325	.000
					Division Dummy	.043	.309	.759
2	.176	.174	.143	.008	(Constant)		-1.453	.152
					Division Dummy	.054	.420	.676
					Internal Legitimacy	.417	3.245	.002
3	.205	.029	.156	.010	(Constant)		-.005	.996
					Division Dummy	.059	.461	.647
					Internal Legitimacy	.371	2.816	.007
					Business Certainty	-.177	-1.339	.187
4	.272	.067	.212	.004	(Constant)		-2.017	.049
					Division Dummy	.037	.302	.764
					Internal Legitimacy	1.668	2.661	.011
					Business Certainty	1.241	1.817	.075
					Internal Legitimacy x Business Certainty	-1.676	-2.113	.040

Table 6
Moderation of Business Certainty Between Internal and External Legitimacy
and Operating Margin

Model	R ²	Chg in R ²	Adj R ²	Sig Adj R ²	Variables entered	β	T	Sig
External Legitimacy – Global Logistics								
1	.027		-.031	.504	(Constant)		-.415	.683
					External Legitimacy	.163	.683	.504
2	.191	.164	.090	.183	(Constant)		1.005	.330
					External Legitimacy	-.123	-.447	.661
					Business Certainty	-.496	-1.804	.090
3	.289	.098	.147	.152	(Constant)		1.676	.114
					External Legitimacy	-1.588	-1.507	.153
					Business Certainty	-5.788	-1.568	.138
					External Legitimacy x Business Certainty	4.615	1.437	.171
Internal Legitimacy – Global Logistics								
1	.169		.120	.080	(Constant)		-1.330	.201
					Internal Legitimacy	.411	1.861	.080
2	.297	.128	.209	.060	(Constant)		-.167	.869
					Internal Legitimacy	.346	1.624	.124
					Business Certainty	-.363	-1.705	.107
3	.386	.089	.263	.057	(Constant)		-1.464	.164
					Internal Legitimacy	1.627	1.820	.089
					Business Certainty	1.931	1.229	.238
					Internal Legitimacy x Business Certainty	-2.436	-1.473	.162
External Legitimacy – Local Consulting								
1	.244		.221	.003	(Constant)		-1.480	.149
					External Legitimacy	.494	3.216	.003
2	.248	.004	.200	.012	(Constant)		-1.239	.225
					External Legitimacy	.518	3.109	.004
					Business Certainty	.066	.398	.693
3	.418	.170	.360	.001	(Constant)		-3.209	.003
					External Legitimacy	3.007	3.521	.001
					Business Certainty	2.969	2.993	.005
					External Legitimacy x Business Certainty	-3.111	-2.960	.006
Internal Legitimacy – Local Consulting								
1	.251		.227	.003	(Constant)		-.963	.343
					Internal Legitimacy	.501	3.271	.003
2	.252	.001	.204	.011	(Constant)		-.749	.459
					Internal Legitimacy	.512	3.142	.004
					Business Certainty	.039	.239	.813
3	.305	.053	.235	.011	(Constant)		-1.675	.104
					Internal Legitimacy	1.707	2.113	.043
					Business Certainty	1.102	1.525	.138
					Internal Legitimacy x Business Certainty	-1.356	-1.509	.142

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