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RESEARCH ARTICLE

LI Wei'an, LI Baoquan

Why TNCs try to make their subsidiaries sole proprietorship enterprises in China?
—An analysis of TNCs' strategy on equity ownership structure

Abstract A review on the evolution of the Transnational Corporations' (TNCs) equity ownership structure in their subsidiaries in recent 20 years reveals an increasingly clear preference for sole proprietorship. Based on results of the prior researches, this paper presented a two-stage evolutionary model to explain the underlying reasons of the tendency in China. It is shown that the TNCs' strategic choice for their subsidiaries' equity ownership structure is a decision-making process and result, which makes the parent company, as the principal part, based on the current business strategies of the parent company (local or global integration) at the premise of the investment environment of host country, pursue possibly unproductive receipts by choosing or changing the structure of the equity ownership.

Keywords Transnational Corporations (TNCs), sole proprietorship in joint ventures, strategy on equity ownership structure

摘要 考察20多年来跨国公司在华企业的股权结构变动趋势, 可发现其独资倾向日益明显。借鉴国内外学者关于跨国公司股权结构战略的研究成果, 在东道国为新兴

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LI Wei'an (✉)
Business School, Nankai University, Tianjin 300071, China
E-mail: liweian@public.tpt.tj.cn

LI Baoquan
Industrial and Commercial Bank of China (ICBC), Beijing 100032, China
E-mail: libaoquan@icbc.com.cn

市场经济国家前提下，可提出一个跨国公司股权结构战略两阶段演进模型，从而揭示跨国公司在华独资倾向增强的深层原因，即追求股权结构战略改进的预期收益。

关键词 跨国公司，独资倾向，股权结构战略

1 Introduction

Currently, after a few years' operation in China, more and more joint ventures or cooperative enterprises had converted into joint ventures controlled by its parent company through increasing its capital or equity, or into sole proprietorship. This kind of trend is clearly demonstrated by the provincial and municipal statistics. For example, according to the statistics of the Foreign Economic and Trade Commission of Tianjin, foreign-invested enterprises increased 930 million US dollars investment in Tianjin from January to October in 2001, of which 810 million US dollars are invested directly by foreign parts, which accounts for 21.7% of the total increment of the contractual foreign investment during the same period of time. In recent years, micro-level specific cases also become common, with some typical cases such as: Alcatel increased its shares of Shanghai Bell from 31.65% to 51%; Samsung Group increased its shares of Samsung Electronics from 50% to 91.5%; Procter & Gamble (P & G) increasing its shares of Beijing Panda from 50% to 99%; sole proprietorship enterprises owned by Dupont in China increasing to six. More and more facts show that those transnational corporations having operated for many years in China followed a track from joint ventures to controlling the equity and then to owning enterprises solely.

The TNCs' Corporate Governance Research Team of the International Business School of Nankai University once administered a two-year survey about 200 foreign-funded enterprises (The three kinds of foreign-invested enterprises included Sino-foreign joint ventures, cooperative businesses and exclusively foreign-owned enterprises in China) from 1999 in Tianjin Development Zone (over 10 million US dollars registered capital). The investigation shows that after several years' development, TNCs tend to expand their capital investment or equity in China. By the end of 2000, the statistics show that there have been 2721 three kinds of foreign-funded enterprises in Tianjin Development Zone, including 1123 joint ventures, 67 cooperative enterprises and 1531 solely owned ones. Even among those joint ventures and cooperative enterprises, the foreign shares reached 65.8% and 69.9% respectively.

Equity ownership structure is the core element that determines the parent company's control rights over their subsidiaries. When investing in another country or region, TNCs should, first of all, identify the strategy of their equity

Table 1 The foreign investment scale and foreign capital ratio in Tianjin Economic and Technological Development Zone by the end of 2000

Classification by investment mode	Enterprise number	Contracted investment ($10,000)	Contracted foreign capital ($10,000)	Proportion of foreign capital (%)
Joint ventures	1123	581,955	382,724	65.8
Cooperative enterprises	67	68,881	48,142	69.9
Sole proprietorship enterprises	1531	687,859	687,366	99.9
Total	2721	1,338,695	1,118,232	83.5

Source: Li (2001)

ownership structure, i.e. a sole proprietor or joint ventures. For every country, especially for developing countries, to define the equity ratio of joint ventures is an important aspect in regulating the Foreign Direct Investment. The equity proportion is not only linked with benefits distribution and risk share, but also generally becomes the basis for stakeholders to share this company's control, and thus it becomes the most direct factor that affects all partners' controlling this joint ventures and other means of control, such as the appointment of key positions, budget and resource allocation rights, are mostly derivatives of equity. Why TNCs would prefer solely owned enterprises in China? The underlying causes will be analyzed in this paper from the perspective of the parent company's strategy for their subsidiaries' equity ownership structure.

2 Review of overseas' studies on TNCs' equity ownership structure strategy

2.1 Theoretical researches

Based on different research approaches, there are four kinds of theories (Li, 2001). The first might be Internalization Theory or Transaction Cost Theory (Williamson, 1975; Buckley and Casson, 1976; Hennart, 1982; Anderson and Gatignon, 1986; Casson, 1987). This theory stresses that the transnational corporations tend to solve the problems of excessive internal transaction costs caused by information asymmetry, market failure and opportunistic behavior by improving equity ownership structure. The second theory might be Bargaining Theory, which believes that the equity ownership structure of TNCs' subsidiaries is determined by TNCs' bargaining power with the host governments (Stopford and Wells, 1972; Fagre and Wells, 1982; Lecraw, 1984; Kobrin, 1987). The third theory could be regarded as Resources Determinism, which means that when making overseas investment, the TNCs' options of equity ownership structure is influenced by their dependence on local strategic assets and operating resources (Hymer, 1960; Rugman, 1981; Dunning, 1995). The fourth theory was derived from the New Institutional Economics, which believes that the institutional factors play a major impact in the ownership structure. These factors consist of risks faced by the host country, the host government's equity ratio control and cultural differences (Beamish and Banks, 1987; Contractor and Lorange, 1988; Vanhonacker, 1997). To sum up, these theoretical researches of the foreign scholars on TNCs' strategic choice for equity ownership structure have some clear limitations. These researches are mostly static, which often only paid attention to the equity strategy choice of TNCs when they advanced into overseas markets initially and ignored the time factor and learning effects. Theses researches had not dynamically taken into account the strategic re-choice of TNCs when they had operated for several years overseas.

2.2 Empirical researches

The study of Gomers-Casseres (1989, 1990) shows that TNCs' equity ratio in their overseas subsidiaries is positively related with their familiarity with the host country. Delios and Beamish (1999) also provided us with favorable evidence, for example, TNCs' overseas business operating experience, in terms of operating years, is also positively related with equity ratio. With the same approach, Caves and Mehra (1986) thought that TNCs prefer sole proprietor if their overseas business experience is measured by the number of the countries they had entered. Park and Lee (2001) also studied several TNCs' empirical cases of the United States, South Korea and Hong Kong in Shandong Province of China, which shows that TNCs would prefer sole proprietor at a higher proportion if their dependence on the local resources is not strong and their products are export-oriented. For example, some TNCs of South Korea had launched a number of small and medium manufacture enterprises in China and the vast majority of them chose this kind of model.

By reviewing the results of the researches on TNCs' strategy for their subsidiaries' equity ownership structure, it can be found that during the process of direct overseas investment TNCs always determine their strategy under the name of the parent company as well as considering their strategic interest of global development. This is a decision-making process that TNCs take the initiative to adapt to the host country's regulatory policies, legal and market environment, which are the prerequisites for the development of transnational corporations. This is also a dynamic process which takes into account the first strategic arrangement when TNCs first enter into host countries, as well as their strategic change after TNCs have adapted to the host country's regulatory policies, legal and market environment.

To explore the inner reasons of TNCs' sole-proprietor-tendency for overseas investment in China, in addition to the existing results, the dimensions of time factor and learning effects are introduced and the theoretical model and analysis framework are constructed in this paper.

3 Two-stage model of TNC's strategic choice for their subsidiaries' equity ownership structure

3.1 Definition of research object

As the host countries may be divided into mature market-economic countries (MMC) and emerging market-economic countries (EMC), and TNCs can also be divided into two different kinds according to their home countries: one is from EMC (EMC') and the other from the MMC (MMC'). Therefore, the research object could be divided into the following four categories (Table 2).

Table 2 Four main types of equity ownership structure strategic choice

(MMC, MMC')	(MMC, EMC')
(EMC, MMC')	(EMC, EMC')

Because China is a typically emerging market economic country, and China's investment from transnational corporations includes both mature market economies, and emerging market economies, therefore, this study will focus on two types such as (EMC, MMC') and (EMC, EMC'), that is, the premise of this study is that the host country belongs to emerging market economic country.

3.2 The proposed analytical model

Integrating the preceding four kinds of theories, the time factor and learning effects were brought into the study and an analysis model was proposed.

If Ei is used to represent the expected benefits of a TNC, *Cpi* represents its whole productive cost such as raw materials procurement, management fees, taxes and other costs (overt and quantifiable), *Cdi* or *Cti* represents its unproductive costs (hidden and difficult to quantify) and *Cti* and *Cdi* represent internal transaction costs (*Cti*) and external risk costs (*Cdi*) alternatively reflected a joint venture's development. If this TNC chooses joint venture style, the cost of TNC is *Cti*; and if it prefers sole proprietorship, then its cost style belongs to *Cdi*.

Ni presents its net benefits after deducting all kinds of cost. Therefore, we can come to its investment benefit model when the TNC invests in a host country

$$Ni = \alpha i\ (Ei - Cpi - Cti \text{ or } Cdi) \tag{1}$$

Note: $0 \leqslant \alpha \leqslant 1$, this parameter is determined by equity distribution policy. It can be found from this analysis that the whole benefit model of TNCs from overseas investment is given as

$$\Sigma Ni = \Sigma \alpha i\ (Ei - Cpi - Cti \text{ or } Cdi) \tag{2}$$

Note: $i = 1, 2, 3, 4\ldots, n$

On the basis of the above model, it is believed that, when the host country is an emerging market economic country, the transnational corporations (either MMC' or EMC'), in the process of equity structure strategic options, often go through two evolution stages from joint venture or cooperation to sole proprietor. Thus, this evolution is also divided into two phases (Please refer to Fig. 1. tt': internal transaction costs Line; dd': external risk cost line; AA': expected receipts curve; FF': expected revenue curve. For the convenience of analysis, in this figure the productive cost is hidden in tt' and dd').

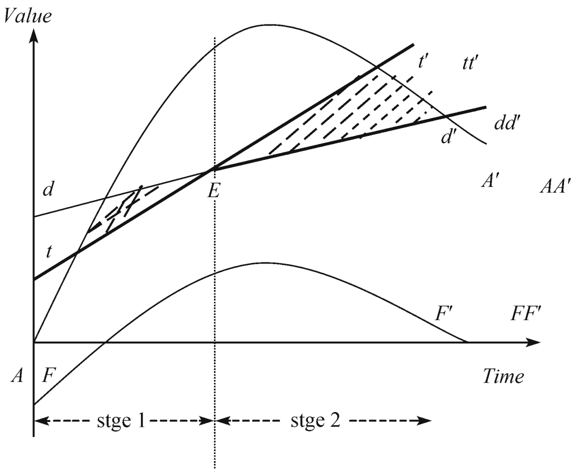

Fig. 1 Evolution stages of TNCs' equity ownership structure choice in a host country

Stage 1: It is more important for TNCs to gain the access to resources than the right of control, and therefore, joint ventures or cooperation is a rational choice.

Before the E point, where the internal and external transaction costs offset the cost of risk, is the first stage. During this phase, as the host country is emerging market economic country, the government often strictly limits the foreign share ratio and supports joint ventures or cooperation, hence restricting sole proprietorship. Second, because of some disadvantages of the host countries such as the immature market, the imperfectly legal system and serious market failures, it is more beneficial for transnational corporations to achieve the right of access to local resources than the acquisition of control when they enter into the host country for the first time. Once again, because it is the first time for TNCs to enter the host country, the costs of external risks (*Ct*) clearly outweigh internal transaction costs (*Cd*). Furthermore, due to the low level of global economy integration and the poor traffic and communication conditions, TNCs, in accordance with the principles of cost-benefit, usually take the scattered overseas enterprises as the independent units to determine their ownership structure strategies so as to achieve maximum benefits. Therefore, in this stage, given many environmental factors premise in host country and the identified expected benefits, transnational corporations are more inclined to choose a joint venture or cooperation, namely prefer *tE* to *dE* as a current cost curve. It is available for TNCs to gain their benefit shown by the triangle shadow to the left of E point, which is the unproductive benefit arising from equity ownership structure strategic choice.

Stage 2: After operating for several years and with the improvement of the investment environment, and TNCs play more emphases on control rights in order to pursuit maximum returns from global business strategies, and they begin to change their overseas enterprises into joint ventures controlled by parent company or even sole proprietorship enterprises.

After the E point in Fig. 1, first, with the increasing opening-up level, the host government has relaxed controls on foreign equity ratios clients. Second, the host country' market becomes more effective and the level of resources allocation through market improves significantly, so the dependence of TNCs on the host country resources declines. Once again, as TNCs' operating experience in the host country accumulated and the transaction costs of joint venture increased constantly, the internal transaction costs (*Ct*) rise higher than external risk costs (*Cd*). In addition, with the rapid development of the modern transportation and communication, the national barriers to the global market are gradually removed, and TNCs start to choose large-scale integrated strategy and the control becomes more important. Thus, in the second phase, because the environmental factors are improved in the host country and the level of globalization is further enhanced, TNCs tend to change their overseas invested enterprises into those controlled by parent company or sole proprietorship enterprises. They are more inclined to choose Ed' rather than Et' as the cost curve. After this evolution of equity ownership structure strategy, TNCs are able to acquire certain benefit shown by the triangle shadow to the right of E point, this kind of benefit belongs to unproductive proceeds through strategic improvements of the equity ownership structure. It is the pursuit on non-productive revenue based on the improvement of equity strategies that comprises the fundamental impetus driving TNCs to turn their joint ventures and cooperation to sole proprietorship enterprises.

4 Empirical analysis of the sole proprietorship tendency of transnational corporations

It has been 20 years since the first Sino-foreign joint Venture—Beijing Air Catering Limited Company—was established in 1980, which signified the beginning of the transnational corporations' investment in China. The domestic scholars divided this 20-year-time into several phases from different perspectives (Liang, 1995; Pan,1996). The model in this paper is used to the analysis, considering such standards as the extent of foreign-ratio deregulation, the degree of domestic market maturity, the degree of legal system improvement, the overall business strategy for the parent company, the 20 years has been divided it into two stages: the first is from 1979 to 1991 and the second from 1992 up to now.

4.1 Stage 1—from 1979 to 1991

As to the investment environment for the TNCs, the government's regulation for foreign share ratio was stricter before 1992. Moreover, the government encouraged the foreign investment to take the way of joint ventures or cooperative enterprises, but strictly controlled establishing sole proprietorship enterprises.

From the view of the maturity of domestic market, the goal of socialistic market economy has not yet clearly stated at that time, and much attention still has been paid to the argument on the economic system reform direction, plan or market. The SOEs were still the largest share in the economic system, and the proportion of other economic sectors was obviously small, and the level of market allocation was quite low. After the price reform in the late 1980s, China's commodity market was eventually formed in the early 1990s, but the labor market and the capital market were still on the primitive phase.

Regarding the partners that foreign company faced, the SOEs were still in the dominantly economic position in China, because they had the policy advantage and knew the rule of the game. "Guanxi" was the indispensable resource that Chinese enterprises used in their operation (Li, 2001). Domestic enterprises, especially SOEs had the geographical advantage, which was the main factor influencing foreign enterprises' choosing the way of co-operation.

From the view of TNCs entering China in this phase, first, these companies mainly came from Hong Kong, Macao, Taiwan province of China and the emerging market economy countries of the Association of South East Asian Nations (ASEAN) (See Table 3). In these areas, the level of global integration strategies was very low, and its main purpose was to get the investment returns at that time. Second, most of them focused on the low-risk and short-investment-return-period industries, such as manufactures, real estate and catering services. Third, in terms of size, most were small-scaled. According to the statistics, the foreign direct investment of the projects during 1979−1991, based on the actual use of foreign investment, was 0.64 million US dollars on the average.

Table 3 The distribution of country sources in the Chinese-funded enterprises during 1983−1991

Country sources	1983−1986 (%)	1987−1991 (%)
Hong Kong, Macao Taiwan Region	83.0	72.0
Japan	5.6	4.0
USA	4.0	5.0
EU	2.6	1.0
ASEAN	3.1	2.6

Source: Wu (2000)

In addition, from the view of resource-intensity, labor-intensive is the dominance. It is not difficult to see from Table 4 that even at the end of 1995, in the foreign invested manufacturing enterprises, more than half were labor-intensive enterprises, the capital-intensive and technology-intensive enterprises accounted for only 22.73% and 26.85%. From that, it can be seen that the main motivation of TNCs investing in China is to make full use of low labor costs.

Table 4 The resource-intensity for the foreign invested manufacturing enterprises by the end of 1995

Resource	Intensity (%)
Capital	22.73
Technology	26.85
Labor	50.42
Total	100.00

Source: Collection from the project coordinator from the side of the Ministry of Foreign Trade of the People's Republic of China and OECD 2002 (Although Table 4 uses the data of 1995, they show the resource degree of foreign investment before 1992)

Before 1992, China's government strictly controlled the foreign-ratio and the level of market allocation was very low. In order to reduce the risks of external costs, obtain the advantage of local resources, make them stand steadily as early as possible, most TNCs chose of way of joint ventures. According to the statistics, during the period from 1979 to 1991, the state approved 42,503 new foreign-funded enterprises, and among them, the number of joint ventures was 24,690, sole proprietorship, cooperation and other types of enterprises are 6180, 11,566 and 67 respectively, the proportion of joint ventures reached 58.1%.

4.2 Stage 2—from 1992 up to now

Compared with the first phase, from 1992, particularly after 1997, qualitative changes in the investment situation have taken place in the following four aspects.

First, the restrictions are gradually relaxed on the equity ratio of foreign investment. The Foreign Investment Corporation Acts enacted in 1995 has provided a legal support for the integrations of foreign corporations and Chinese companies. The Industrial Catalog for Foreign Investment, which was first enacted in 1997 and revised later in 2002, has further relaxed the restrictions on equity ratio, abolished the difference in the taxes and exchange rates policies, and also relaxed the limitation on business areas. With China's joining the WTO at the end of the year 2001, the limitations have been weakened and enterprises have developed freely in a much larger space.

Second, the market has become more and more matured. The 1992 Speech Delivered by Deng Xiaoping has cleared up the confusion between planned economy and market economy. The market of labor, capital and products has developed more rapidly during ten years. By the end of 2000, the value of stock market in China has almost reached 50% of Chinese GDP. The GDP has increased continuously at a ratio of 10% in 20 years, which shows a brighter future. In addition, the opening-up has been accelerated, and the situation of comprehensively opening along the rivers (Yangtze River), the railways (Longhai Line and Lanxin Line) and borders has gradually formed since 1992.

Third, the "country risk" has further reduced and the confidence of overseas investment increases constantly. According to the survey in *Fortune* of Dec. 1999, 95% of TNCs believe that China will be the best investment area in next five years, and 63% of them which have not invested in China have planned to invest in China in next five years.

Fourth, a considerable number of joint ventures have the problem that the internal transaction costs have been enhancing constantly after developing for ten more years. Because there are some differences in business ideas, management methods, and corporate culture between the two sides of joint ventures, they have to spend much time and energy on internal coordination. That General Managers of joint ventures are taken charge of Chinese and foreigners by turns has proved this. In recent years there also have been many cases of the dissolution of joint ventures. For instance, two joint ventures of P & G Company in Beijing and Guangdong of China, as a result of the more and more differences in such areas as product market positioning between the two sides of joint ventures, the Chinese company ultimately withdrew from the joint venture. Another example is Samsung Electronics Co. Ltd., which is a joint venture of Chinese and South Korea. When it was founded in 1993, the two sides each had 50% of the market share. However, in 1996, the company started losing due to the market of Video Cassette Recorder (VCR) shrinking, the Chinese company removed most of the fund in 1997. Now South Korea has held the shares of 91.5%.

As the investment environment of China has markedly improved, the parent companies have changed hugely in business ideas and management methods. First, more and more transnational corporations implement the global integration strategies and emphasize the control of the parent company to subsidiaries. Second, the universal use of communications, particularly the application of Internet technology, has improved the operational efficiency and reduced supervision costs, so the management capacity of parent companies has been increased greatly. At the same time, because global economic liberalism ideas are surging, the degree of international economic integration has been raised unprecedented, and the barriers of countries have been increasingly weakened, which provide the possibility of global integration strategies of the parent companies of TNC.

Considering the effect of the two sides of the factors, the transnational corporations have been integrating the foreign invested enterprises in China. Therefore, a new phenomenon comes forth that the transnational corporations control the business in China by setting up regional holding companies (Holding Company) in China. For example, Japanese Toshiba set up an investment holding company in 1995 and France Michelin established an investment holding company in January 2002 as its head office in China, these holding companies created conditions for establishing the internal market.

Since 1992, especially after 1997, establishing sole proprietorship enterprises has become the preferred investment method. According to the statistics, during 1992−1996, there were 241,317 foreign-invested enterprises, which were approved by our government, including 149,330 joint ventures which continued to maintain its dominant position for the percentage of 61.9%. However, from 1997 to October of 2001, the situation has changed significantly. In the 100,982 new foreign-invested enterprises that have been approved by our government, there are 52,081 sole proprietorship enterprises which hold the percentage of 51.6%. The sole proprietorship enterprises get the dominant position instead of joint ventures.

5 Conclusions

This paper shows that the TNCs' strategic choice for their subsidiaries' equity ownership structure is a decision-making process and result, which makes the parent company, as the principal part, based on the current business strategies of parent company (local or global integration) at the premise of the investment environment of host country, pursue possibly unproductive receipts by choosing or changing the structure of the equity ownership. The TNC's strategy of equity ownership structure is dynamically changing with the investment environment and business strategy of parent changes. In the host country for the emerging market economies, for example, in China, the TNCs' strategic choice of equity ownership structure strategy will develop from joint ventures, cooperative enterprises to the sole proprietorship enterprises.

The policy implication of this study is as follows: first, it provides a general framework to the analysis of the TNCs' strategic choice of their subsidiaries' equity ownership structure in China, namely, the transnational corporations should adjust its equity ownership structure choice with the changes of investment environment of the host country and its own strategy; second, for those TNCs' subsidiaries in China, which have had problems in the operation of joint venture, they can carry out the intention of their parent companies' better by adjusting its equity ownership structure choice, but not disinvestment; third, as the increasing tendency of TNCs' subsidiaries to be sole proprietorship enterprises, how to achieve the interests of the host country (in China, how to guide the transnational corporations to take part in the restructuring of SOEs and supporting the development of the western regions, etc.), will become the topic which the government must find responsive measures as soon as possible.

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