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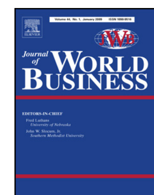

Business groups and foreign direct investments by developing country firms: An empirical test in India

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ABSTRACT

Drawing on recent theoretical explanations, we develop hypotheses on the relationship between business group affiliation and FDI by developing country firms. We hypothesize a positive relationship between business group affiliation and FDI overall, as well as between business group affiliation and FDI into advanced countries and into developing countries. In addition, we argue that the impact of business group affiliation on FDI varies in strength among business groups based on their size and diversification. We also empirically test the hypotheses in a sample of firms from one large and important developing country, India.

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1. Introduction

Rapid growth in foreign direct investments (FDI) by developing country firms is among the most significant development in international business in recent decades (Luo & Tung, 2007; Mathews, 2006; UNCTAD, 2004). FDI by developing country firms pose a theoretical puzzle because these firms are thought to lack sophisticated firm specific capabilities, especially in R&D and marketing, considered critical in extant theory to overcome liabilities of foreignness and invest overseas (Luo & Tung, 2007; Mathews, 2006; Ramamurti, 2009; Wells, 2009). Research has advanced new theoretical explanations for developing country firm FDI to address this puzzle (Luo & Tung, 2007; Mathews, 2006; Ramamurti, 2009). Because their organizational mechanisms and competencies are well suited for the underdeveloped and late industrializing contexts of developing countries, business groups occupy dominant positions in a number of developing countries (Amsden & Hikino, 1994; Hikino & Amsden, 1994; Khanna & Palepu, 2000). Although there is a large body of literature on business groups in developing countries, the role of business groups in promoting FDI has not received much research attention.[1] Could business groups facilitate FDI of firms from developing countries?

Since large numbers of firms in many developing countries are affiliated to business groups, if business groups facilitate FDI of their affiliates, this would contribute to our understanding of the drivers of developing country firm FDI. The finding can also help managers of advanced country multinational corporations (MNCs) assess the competitive threat from developing country firms. Understanding whether business groups facilitate FDI of their affiliates is therefore theoretically and practically important.

This study draws on three recent theoretical explanations for FDI by developing country firms and the literature on business groups to develop hypotheses relating business group affiliation and FDI by developing country firms. The core argument advanced in this study is that business groups exemplify the motivation and means put forth in the new theoretical explanations for developing country firm FDI, and are therefore well placed to facilitate FDI of their affiliates. We, therefore, hypothesize a positive relationship between business group affiliation and FDI of developing country firms. We also argue that advantages of business groups apply in both advanced countries and in other developing countries. Hence we hypothesize a positive relationship between business group affiliation and FDI into both advanced countries and developing countries. Finally, we argue that differences among business groups, in terms of their size and diversification, affect the relationship between business group affiliation and FDI. Specifically, we hypothesize that affiliates of larger business groups have greater FDI than affiliates of smaller business groups, and that affiliates of more diversified business groups have lower FDI than affiliates of less diversified business groups.

The study also tests the hypotheses on a large sample of firms from one large and important developing country, India. While India provides an ideal context to test the hypotheses because of the availability of detailed firm level data covering a large proportion of firms in the economy, India is not a unique context. As in India, utilizing similar organizational mechanisms and

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[1] Bhaumik et al.'s (2010) examination of the relationship between family ownership (which often coincides with, but is not the same as business groups) and FDI may be considered a rare exception.

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competencies, business groups are dominant in a number of other developing countries that are historically, culturally, and geographically distinct including Argentina, South Korea, South Africa, Taiwan, Turkey, Malaysia, Mexico, Brazil, and Chile (Amsden & Hikino, 1994; Guillen, 2000; Khanna & Palepu, 2000; Leff, 1976; Toulan & Guillen, 1997). India is a reasonably representative country to test our hypotheses on the role of business groups in FDI by developing country firms.

2. Theoretical background

A common and well accepted feature of FDI theories is that, to invest and operate businesses overseas, firms must possess advantages in the form of superior technologies or brands to compensate for their liabilities of foreignness (Buckley & Casson, 1976, 1998; Hymer, 1960; Rugman, 1986; Zaheer, 1995). Since developing country firms are thought to lack technological and marketing sophistication, FDI by these firms pose a theoretical puzzle, spurring scholars to seek newer explanations. Three distinct explanations have emerged in the literature.

The first of these explanations holds that developing country firms have a different type of advantage that enables them to overcome liabilities of foreignness and invest in other developing countries. Proponents of this explanation argue that developing country firms grow in environments with underdeveloped infrastructures and institutions, including unreliable power, inefficient ports and roads, corrupt bureaucracies, political and regulatory uncertainties, and various institutional voids (Khanna & Palepu, 2006; Ramamurti, 2009). Coping strategies that these firms develop to grow despite the adversity gives them an 'adversity advantage' over advanced country firms that are stymied by the challenges when investing in developing countries (Khanna & Palepu, 2006; Ramamurti, 2009, p. 409).

The second theoretical explanation posits that developing country firms gain the advanced technological and other competencies necessary to overcome liabilities of foreignness through a process of *linking*, *leveraging*, and *learning* (LLL) (Mathews, 2002, 2006). Specifically, proponents of this explanation argue that developing country firms gain access to the advanced firm specific resources they lack by *linking* with advanced country firms (through such inter-firm relationships as buyers, outsourcing vendors, and strategic alliances), and then *leveraging* these new resources by combining them with their own resources. By repeatedly engaging in this process of linking and leveraging, the argument goes, developing country firms *learn* to absorb and deploy resources of increasing sophistication and complexity which enables them to overcome liabilities of foreignness and invest overseas.

The third theoretical explanation holds that developing country firms use FDI as a spring board to enhance their competitive positions relative to advanced country MNCs that have entered their home markets (Luo & Tung, 2007). A distinguishing feature of the spring board perspective is that it suggests a motivation, and not just sources of advantage, or means, to explain developing country firm FDI. According to this perspective, the need to protect their dominant positions at home from foreign firms entering their markets provides developing country firms the motive for FDI. Their strong market positions and closeness to the attractive and growing home markets provide the means to pursue FDI. A number of Brazilian, and Russian firms, for example, have used their profitable positions in the large and growing domestic natural resource markets to finance foreign acquisitions in downstream distribution assets (Ramamurti, 2009). Similarly, Indian and Chinese manufactures including Tata Steel, Tata Motors, and Haier have used their strong positions in the profitable and growing home markets to finance FDI (Ramamurti, 2009). Luo and Tung (2007) liken the advantages provided by strong home market positions to 'home court' advantages that are not easily matched by foreign firms because of their liabilities of foreignness, and because of the favorable treatment domestic firms may enjoy from developing country governments that are eager to support domestic champions.

3. Hypotheses

3.1. Business groups and FDI by developing country firms

Business groups are collections of firms with common ownership and control by a family and with entrepreneurial coordination among the firms (Guillen, 2000, p. 362–363; Khanna & Rivkin, 2001, p. 45; Leff, 1978, p. 663). Business groups are well adapted to the underdeveloped and late industrializing conditions of developing countries. They occupy dominant positions in the economies of a variety of developing countries including India, South Korea, Taiwan, Turkey, and Chile (Amsden & Hikino, 1994; Guillen, 2000; Khanna & Palepu, 2000; Leff, 1976, 1978, 1979). We argue that their organizational mechanisms, competencies, and dominant positions at home, make business groups exemplary with respect to the motivation and means proffered in recent theoretical explanations for developing country firm FDI. We develop these arguments below.

As argued by proponents of the adversity advantage explanation, developing country firms have evolved coping strategies to grow in the challenging environments of their home markets. Developing country firms, for example, have learned to operate with low capital and operating budgets, and have developed product strategies tailored to the challenges posed by these markets (Dawar & Frost, 1999; Piramal, 1996; Prahalad & Lieberthal, 2003; Ramamurti, 2009). Business groups are particularly successful in these environments because, in addition to sharing the coping strategies of independent firms, they also utilize additional organizational mechanisms to cope with the challenges of developing country environments. For example, business groups use internal markets for production factors, created by pooling the resources of group firms, to compensate for the underdeveloped external factor markets (Khanna & Palepu, 2004; Leff, 1976, 1979). Similarly, by staking the reputation of the group as a whole, business groups signal their credibility in honoring contracts to overcome the underdeveloped external environment for contract enforcement (Khanna & Palepu, 2000). Thus, while some of the coping strategies are common to both independent firms and business groups, organizational mechanisms such as internal labor markets and internal capital markets provide business groups additional adversity advantages that can be used to facilitate FDI of their affiliates.

Business groups also have advantages in each of the three elements that enable FDI in the link, leverage, and learn (LLL) explanation. Acquiring and adapting foreign technology is vital for corporate success in the 'late industrializing' contexts of developing countries (Amsden & Hikino, 1994; Guillen, 2000; Hikino & Amsden, 1994). Consequently, both business group affiliates and independent firms have exposure and experience in establishing *links* with advanced country firms for accessing technologies. Operating businesses in multiple industries, however, provide business groups an advantage over independent firms in establishing *links* with advanced country firms. As argued by Amsden (2009, p. 66), for example, "expertise in many industries gives groups an advantage with large, multi-product vendors that provide them with further knowledge and better industry-level capabilities." Similarly, because of their dominance in domestic markets, business groups have greater visibility and reputation which provide them an advantage in acquiring technologies through

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