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Do indigenous firms incur a liability of localness when operating in their home market? The case of China

Fuming Jiang [a,*], Bruce W. Stening [b,1]

[a] School of Management, Curtin Business School, Curtin University, Western Australia, Australia
[b] Vlerick Business School, BiMBA Program, China Center for Economic Research, Peking University, Beijing, China

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ABSTRACT

Liability of foreignness has been one of the building blocks of theories of multinational enterprises. This paper looks at a parallel issue – the liability of localness that local firms may face as a result of foreign firms' presence in their country. The results show that local Chinese firms enjoy location-based advantages over their foreign counterparts and these, together with their firm-specific advantages, have significant positive effects on their performance. The superior firm-specific advantages of foreign firms appear to erase the magnitude of such effects and create a significant negative impact on local Chinese firms' performance, and this effect is heightened by foreign firms' multinationality advantages. The research suggests that local Chinese firms incur a liability of localness, and the extent of the negative impact of such liability on local firm performance is largely dependent on the relative strength of various advantages that the local and foreign firms possess.

1. Introduction

For at least fifty years, leading international business researchers (most notably Hymer, 1960/1976) have argued that firms operating abroad face considerable challenges and incur additional costs (i.e., a liability of foreignness, or LOF) relative to indigenous firms. These challenges and costs result from their lack of familiarity with local cultural norms and values, different economic, political, and legal systems, lack of experience in foreign markets and the geographic distance between the home and foreign host countries. As a result, an enterprise that operates outside of its national boundaries will incur additional costs relative to the local firms in the host country market (Miller & Parkhe, 2002; Zaheer, 1995). A number of studies have re-examined this issue and in general confirmed that LOF-based competitive disadvantage still exists and affects firms' performance adversely in foreign markets (e.g., Miller & Parkhe, 2002; Zaheer, 1995; Zaheer & Mosakowski, 1997). Nachum (2003) and Kronborg and Thomsen (2009) challenged the conventional wisdom of the LOF. They argue that the LOF may not exist, and that foreignness may be either an asset or a liability depending on the circumstances (Nachum, 2010). While most studies of international competition are undertaken from the perspective of foreign firms, we argue that local firms are just as important to examine. How they view the nature of international competition may be of strategic importance to all of the players in the game and to their competitive positions in this 'playground'. This study goes beyond previous LOF studies and looks at the players on 'the other side of the fence', namely locally owned firms operating in their home country, suggesting that these firms may incur added costs in doing business at home; that is, they may suffer from a *liability of localness*, or LOL.

From an institutional perspective, Perez-Batres and Eden (2008) first defined the concept of LOL as the added cost faced by local firms on account of sudden changes in the regulatory environment within the host country, allowing inward foreign investment and leading to a change in the 'rules of the game' for domestic firms. They elaborate that LOL would result from institutional misalignment where newly formed institutions would favor foreign firms over local firms. Regulatory punctuations would undermine and ultimately change the host market institutions that guide local firms' business practices. The net effect would be that local firms would not be familiar with the new 'rules of the game', incurring a liability of localness, inducing a negative impact on local firms' performance. Our study extends Perez-Batres and Eden's in two important dimensions. First, Perez-Batres and Eden suggest that LOL occurs when sudden institutional changes (i.e., punctuations) take place. We argue that the LOL and the effects of it on local firm performance are not limited to such punctuations, but may remain present for as long as the foreign firms exhibit a significant

* Corresponding author. Tel.: +61 8 9266 1136; fax: +61 8 9266 7897.
E-mail addresses: fuming.jiang@curtin.edu.au (F. Jiang), bruce.stening@bimba.edu.cn (B.W. Stening).
[1] Tel.: +86 10 6275 3098; fax: +86 10 6275 3098.

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competitive advantage over their local counterparts. This is particularly evident in the context of an emerging country such as China. Economic liberalization began about three decades ago in China with the so-called 'Reform and Opening Up' initiated by Deng Xiaoping, and where the new institutional arrangements (involving some fundamental changes to economic rules) have already permeated to the minds and perceptions of managers. Second, even if local (surviving) firms have successfully adapted to the new way of doing business locally, they are for the most part perceived as less legitimate (i.e., having fewer firm-specific advantages) than their foreign counterparts. This can negatively affect local firms' performance. Accordingly, our central research question is: Do superior competitive advantages of foreign firms contribute to the creation of added costs (i.e., LOL) for local Chinese firms? If so, do such added costs have a significant negative impact on local Chinese firms' performance in China?

2. Institutional development and change of competitive landscape

Institutions are social, economic and political bodies that articulate and maintain widely observed norms and rules (North, 1990). Since it opened up its economy and began the process of economic reform in 1978, China has experienced significant institutional change and development particularly in the way that political power is used (Gilley, 2008), the role of government in the economic and business activities, the structure of industries and firms, and the emergence of intermediate institutions such as professional and efficient business support services. Many of those changes and developments have gradually favored foreign investors (Child & Tse, 2001). Following a gradual relaxation of entry restrictions during the 1980s and 1990s, when many previously restricted industries, such as retailing, insurance, medical services, trading, accounting services, and banking were opened up to foreign investors. Since about 2000, there has been a significant shift in governmental policies on foreign investment, aimed at gradually eliminating discrimination against foreign firms in the areas of operating rights. This progressive convergence in the regulatory treatment of foreign and local firms represents an important step toward equality for both sets of players (Luo, 2007). These institutional changes and developments have reduced the costs associated with institutional distance for foreign firms, improving the legitimacy of foreign firms operating in the host market (Zaheer, 2002). Local firms gradually lost the legitimacy that they took for granted under the old institutional arrangements. Therefore, such institutional developments, together with market liberalization, can be expected to decrease the negative effect of the LOF for foreign firms (Zaheer & Mosakowski, 1997). LOL may have been created for local firms, but it might have a negative impact on local firms' performance.

In the last decade or so, China's competitive environment has fundamentally changed. Many foreign firms in China have transformed themselves from foreign investors to strategic insiders, shifting competition from niche to mass markets, from single- to multi-markets, and from structural similarity to multiplicity (Luo, 2007). They are now seeking to expand into and penetrate all market segments (Chen, 2003). Foreign firms are aggressively expanding the scale and scope of their investment in new or existing projects across numerous locations in China. They are continuing to improve their competence building and value-chain localization using corporate capital, fortifying their dominant foothold in certain market segments using the retained earnings accumulated on account of their China-based operations, and replicating their success elsewhere in China (Luo, 2007).

Local firms in transitional economies often rely heavily on institutional-based strategies as the main source of competitive advantage, whereas their foreign counterparts usually rely on resource-based strategies as their main source of competitive advantage (Hermelo & Vassolo, 2010). Since the set of advantages and disadvantages are both time- and extent-specific (Marinova, Child, & Marinov, 2011), when institutions are impacted by developments such as liberalization and privatization, the traditional and static sources of competitive advantage are replaced by a more dynamic perspective in which advantages are temporal (D'Aveni, 1994). Advantages, such as location-based advantages, that pertain to institutional-based strategies then become less important, while advantages that pertain to resource-based strategies, such as firm-specific advantages, become vital sources of competitive advantage. As a result, local firms struggle to remain competitive while foreign subsidiaries are better prepared to sustain their competitive position and often outperform their local counterparts (Hermelo & Vassolo, 2010). The competitive position of local and foreign firms in China is likely to be determined by the relative strength of their respective competitive advantages in institutional- and/or resource-based strategies that they developed after the sudden change in the 'rules of the game' thirty years ago. This proposition provides the basis for the theoretical framework and the development of hypotheses that are discussed in the next section.

3. Theory and hypotheses

Studies of the advantages held by MNCs implicitly and/or explicitly identify and distinguish between several aspects of competitive advantage. These include firm-specific advantages (FSAs) arising from the possession of certain intangible capabilities; multi-nationality advantages (MNAs) associated with multinational activity per se; and home- or location-based advantages (LBAs) arising from the exclusive access of firms to resources and institutional conditions in their home countries. These advantages together form the competitiveness of firms in global markets. The strength of these advantages can determine the relative competitive position of foreign MNCs and local firms (Nachum, 2003). The existence, strength, and extent of LOL in China will be dependent on the relative strength of these advantages possessed by foreign and local firms, respectively. We adapted Nachum's (2003) three-dimensional model (that is, FSAs, MNAs, and LBAs) with some necessary extensions. In Nachum's (2003) model, the three types of advantage of foreign firms were used to test LOF. We argue that either LOF or LOL is the aggregated outcome of various competitive advantages that are possessed by players from each side when competing in the same (China) market. These determine the strength of LOL. In order to capture the joint impact of the three types of advantage that both local and foreign firms may possess, we incorporated FSAs and LBAs of both foreign and local firms as independent variable constructs in our framework. MNAs that arise directly from undertaking cross-border business activities in subsidiary units in various locations under a common governance structure (Nachum, 2003). These are significant sources contributing to the creation and development of FSAs (Birkinshaw, Hood, & Jonsson, 1998; Dunning, 1988; Rugman & Verbeke, 1992). In our conceptual framework, we included the multinationality advantages of both foreign and local firms as interactive variables that moderate the relationship between FSAs and firm performance. Our conceptual framework is depicted in Fig. 1.

3.1. Firm-specific advantages

Firm-specific advantages have constituted the building blocks of foreign direct investment research since Hymer (1960/1976) first elaborated the need for some FSAs as a necessary condition for foreign activities. FSAs stem from the proprietary assets of MNCs