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Home country institutional environments and foreign expansion of emerging market firms

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ABSTRACT

We propose that home country institutional environment shapes emerging market firms' foreign expansion. We argue that better-developed home country institutional environment promotes emerging market firms' expansion to foreign markets more advanced than the home country, while institutional instability in the home country reduces this propensity. We further hypothesize that the effects of home country institutional environment are contingent on firm-specific government ownership. Data on the foreign expansion of 921 Chinese firms in the period of 1996–2000 provide strong support for the effects of home country's institutional development and institutional instability. We also find that a high degree of government ownership weakens the positive effect of home country's institutional development on emerging market firms' propensity to expansion to more advanced markets.

1. Introduction

International expansion is a process fraught with difficulty for firms, given that host country's environment can be very different from their home countries (Guler & Guillén, 2010). The literature on international business and management of multinational enterprises (MNEs) generally suggests an economic perspective that home country firm-specific advantages such as technology, marketing know-how, general management skills allow companies to overcome the difficulties associated with international expansion (Caves & Porter, 1977; Hymer, 1976). A recent trend in today's globalization process is the rising role of emerging-market multinational enterprises (EMNEs) in international market (Luo & Tung, 2007). Unlike their counterparts from affluent economies, EMNEs usually don't possess so-called firm-specific advantages such as superior technological and managerial resources. They instead invest abroad in pursuit of these advantages (Makino, Lau, & Yeh, 2002). Thus their internationalization represents a different phenomenon that may challenge the existing theoretical frameworks developed for established MNEs (Meyer & Thaijongrak, 2013).

The rapid international expansion from emerging economies with very distinct institutions has attracted a lot of attention among international business researchers (Gao, Murray, Kotabe & Lu, 2010; Lu, Liu, & Wang, 2011; Luo, Xue & Han, 2010) and led to the emergence of an institutional-based view of international business (IB) strategy. Yet in spite of a growing body of evidence documenting the influence of institutional environment on firm strategy and performance (Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004; Hoskisson, Eden, Lau, & Wright, 2000; Peng, 2003; Scott, 1995), relatively less attention has been paid to the role of home country institutional environment in local firms' foreign expansion. In some recent developments, scholars posit that firms from emerging markets expand abroad because of institutional and market constraints they face at home (Luo & Tung, 2007; Mathews, 2006). Despite of the call for more studies on the underappreciated role of home country institutional forces, the theoretical development of and empirical evidence on its impact on firms' international expansion remain scant.

Our theoretical point of departure is the theory of foreign expansion and its emphasis on institutional environment in emerging markets. We seek to show that institutional-based approach can offer an insightful analysis of the impact of institutional environment of emerging markets on indigenous firms' propensity of foreign expansion. The institutional literature has identified two key aspects of institutional environments that critically affect firm strategy and performance. One

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common way of thinking about institutional environment is in terms of the level of institution development. Underdeveloped institutions such as lack of legal protection for property rights, poor enforcement of commercial laws, non-transparent judicial and litigation systems, underdeveloped factor markets, and inefficient market intermediaries all increase transaction and market costs and severely erode the competitiveness of the firms (North, 1990; Peng, 2003). Another aspect of institutional environment relates to institutional instability, which refers to the extent to which institutions in a country change rapidly over time (Li, Poppo, & Zhou, 2008). Rapid institutional changes create a high level of uncertainty, that is, the uncertainty that a focal firm might find difficult to predict the trajectory of institutional changes and timely respond to it in an appropriate way (Fulmer, 2000).

We propose to analyze the home country's institutional environment within which a firm is embedded as a determinant, among others, of the propensity to pursue foreign opportunities and its choice of advanced or less-advanced foreign markets to enter, two of the most fundamental research issues in the international management field. Our core argument is that the level of institutional development and institutional instability that an emerging market firm faces in its home country impose very distinct influences on its foreign expansion. A relatively developed institution fosters the firm's overseas expansion to an advanced market, whereas institutional instability imposes a constraint on its foreign expansion. More importantly, we propose that government ownership, as a double-edged sword, may interact with two aspects of institutional environments differently in determining firms' propensity to expand abroad.

We test our hypotheses using systematic empirical data on the foreign expansion of 921 Chinese firms from electronic component industry between 1996 and 2000 for three reasons. First, China is a major player in the world economy, and the foreign expansion of Chinese firms has attracted increasingly attentions of scholars in the fields of international business and strategy management (Buckley et al., 2007; Luo & Tung, 2007; Wu, 2013). Second, over the past two decades, China has experienced dramatic institutional changes (Fan, Zhang, & Robinson, 2003; Fan, Zhang, & Zhang, 2004; Naughton, 2007). It thus provides an ideal setting to examine the effects of both the level of institutional development and institutional instability on firm's decision of overseas expansion. Third, Chinese firms have a long tradition of building government ownership to obtain access government resources and preferential treatments, but meanwhile invite political interferences (Chen & Wu, 2011; Gu, Hung, & Tse, 2008; Sheng, Zhou, & Li, 2011). Therefore, academics are particularly interested in the unique characteristics of firm government ownership in mitigating or enlarging the institutional influences in China.

By integrating the international expansion literature with the institutional theory, we strive to contribute to both research traditions. We extend prior work on foreign expansion by emphasizing home country institutional environment as opposed to firm-specific advantages developed at home. This study also contributes to the research on institution environment by unwinding institutional environment into two distinct aspects: the level of institutional development vs. institutional instability. We argue and empirically demonstrate that the level of institutional development and institutional instability differ in their impacts on firms' propensity to expand abroad. We also complement prior research by highlighting how the impacts of institutional development and instability on foreign expansion are contingent upon firm government ownership, an important contextual factor particularly relevant in China (Clarke, 2003; Li & Tang, 2010).

2. Theory and hypotheses

Commonly known as the rules of the game, institutions are defined as the regulative, normative, and cognitive structures that regulate and constrain human activities to provide stability and meaning to social behavior (North, 1990; Scott, 1995). The institution-based view contends that institutional environments in which a firm operates significantly shape the efficacy of its operations and performance (e.g., Hoskisson et al., 2000; Peng, Wang, & Jiang, 2008; Scott, 1995). Thus, firms' strategic choices not only reflect their capabilities and industry conditions, but also represent the formal and informal constraints of their institutional environments (Hitt et al., 2004; Hoskisson et al., 2000; Peng, 2003; Scott, 1995). Such impact is more salient in emerging markets where the pace and scope of institutional changes are comprehensive and unprecedented.

Recently as more and more IB researchers start to probe into the international strategy of firms from emerging economies where institutional environments have distinct features, institution-based view has emerged and been positioned as one leg of the "strategy tripod", in parallel with the traditional industry- and resource-based views in IB literature (Gao et al., 2010; Peng et al., 2008). Researchers suggest that in many emerging markets characterized with lack of market-supporting institutions and inadequate legal framework (Chen & Wu, 2011; Park & Luo, 2001), internationalization thus serves as a strategic means for domestic firms to seek strategic resources and avoid institutional constraints (Lu et al., 2011; Makino et al., 2002; Mathews, 2006). For example, Luo and Tung (2007) present a springboard perspective and point out that EMNEs use international expansion as a springboard to acquire strategic resources, reduce institutional constraints, and overcome latecomer disadvantage in the global competition. In the linkage-leverage-learning (LLL) framework, Mathews (2006) proposes that EMNEs rely on their collaborations with foreign companies or international linkages to leverage their resources, and to learn about how to compete in the global market. Taken an institutional escapism view, Witt and Lewin (2007) argue that foreign expansion is an escape response to home country institutional constraints.

However, extant literature offers conflicting views and limited evidence regarding how institutional transitions in home countries affect the internationalization of emerging market firms. Institutional economics perspective proposes institutional transitions from centrally planned to market based economy reduce the transaction costs, increase the efficiency of market transactions and resource allocation, and facilitate the internationalization activities (Buckley et al., 2007; Gao et al., 2010). For instance, Luo et al. (2010) demonstrate that governmental institutional such as policies to promote outward foreign direct investment offset competitive disadvantages of EMNEs and stimulate them to expand into the global market. Similarly, Gao et al. (2010) discover that institutional forces significantly contribute to Chinese firms' export behaviors beyond the effects of firm resources and industry factors based on a longitudinal data of 18,644 firms. Another view suggests that institutional transition is a dynamic and spiral process involving many fluctuations over time. In some cases, changes in institutional context may cause formally useful elements lose their utility and become obstacles to current players, which creates misalignment between firms and their environment (Witt & Lewin, 2007). In short, the relationship between institutional development and the internationalization of emerging market firms remains unclear.

A possible explanation is institutional changes may have different dimensions that differentially influence EMNEs' propensity of international expansion. Hoskisson et al. (2000) point out