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Corporate expansion during pro-market reforms in emerging markets: The contingent value of group affiliation and diversification[☆]

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ABSTRACT

This study examines how emerging economy firms pursue growth in the domestic market during pro-market reforms. Grounding in the literature on institutional perspective on strategic adaptation during institutional transition, we propose an inverted U-shaped relationship between pro-market reforms and firms' pursuit of growth through new investments. However, the effect of pro-market reforms is likely to vary depending on organizational forms and prior logic of competition. More specifically, we propose that business group affiliation has a positive moderating effect, while prior diversification has a negative moderating effect on the relationship between pro-market reforms and corporate expansion through new investments. Our empirical findings based on a sample of 6072 new investment projects undertaken by 3028 companies in India during 1995–2014 provide robust empirical support for the hypothesized relationships.

1. Introduction

Emerging economies have witnessed significant and broad-based changes in their overall institutional environment with the adoption of pro-market reforms (Hoskisson, Wright, Filatotchev, & Peng, 2013; Wright, Filatotchev, Hoskisson, & Peng, 2005). The primary focus of these reforms has been to make market based exchanges more efficient by removing institutional constraints on economic activities. The institutional transition has created new growth opportunities for firms while simultaneously imposing constraints on their strategic choices (Gaur, 2007; Mukherjee & Kedia, 2012; Xu & Meyer, 2013). For example, initiatives such as deregulation of government controlled industries to allow entry for private firms (Ahluwalia, 2002), removal of regulatory barriers to secure finance, licenses for industry entry and securing inputs have encouraged firms to expand their operations (Singh, 2012). At the same time, pro market reforms have increased the competitive intensity, forcing firms to focus on scale and efficiency in their operations in existing industries, restricting expansion (Carney, Gedajlovic, Heugens, Essen, & Oosterhout, 2011). In such instances, while pro-market reforms may motivate some firms to seize the opportunity to embark on corporate expansion others may find the reforms overwhelming and may not respond due to lack of resources and capabilities, or just inertia.

In this study, we examine this issue by focusing on the role of pro-market reforms on the corporate expansion of emerging market firms. Specifically, we examine how firms respond to pro-market reforms and how firm and network specific factors facilitate or constrain firms' strategic choices. Prior studies on this topic have primarily focused on the impact of pro-market reforms on strategic choices such as internationalization (Dau, 2012), organic versus inorganic growth and network based strategies for corporate expansion (Peng & Heath, 1996), as well as subsequent impact of these strategies on firm performance (Chari & Banalieva, 2015; Cuervo-Cazurra & Dau, 2009). One of the concurrent themes in these studies is that the impact of economic reforms depends on the life cycle of the reforms (Popli, Akbar, Kumar, & Gaur, 2017). Also, the impact of economic reforms is not uniform across all firms. We extend this line of inquiry by arguing that the effect of pro-market reforms at the firm level will be experienced through the strategic actions that firms undertake in response to reforms (Newman, 2000; Popli et al., 2017). Consequently, it is important to examine the relationship between pro-market reforms and firms' corporate expansion strategies.

Pro-market reforms may motivate, or in some cases debilitate strategic change at the firm level. On the one hand, reforms help firms get

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over the inertia to undertake needed changes in their strategic posture (Pérez-Nordtvedt, Payne, Short, & Kedia, 2008). On the other hand, reforms may overwhelm some firms, and in some stages, make firms more rooted in their existing routines and archetypes (Newman, 2000), which may make it difficult to adapt to the changing environment (Aupperle, Acar, & Mukherjee, 2014). Considering that not all firms will respond to reforms in a similar manner, we need to get a deeper insight into how pro-market reforms affect the strategic choices that firms make during institutional transition (Newman, 2000; Peng, 2003).

Pro-market reforms in emerging economies such as India resulted in fundamental and significant changes in the underlying logic of legitimate economic activities (Ahluwalia, 2002). During a period of reforms, firms are exposed to multiple opportunities and threats (Peng, 2003; Peng & Heath, 1996). The development of new institutions changes the rules of the game and opens up many opportunities for firms, while restricting them from pursuing some of the strategies that led to their success in the past (Oliver, 1997). During institutional transition, firms are often unsure about the strategic actions that will bring legitimacy in the changed context. In the early stages, organizations try to match their strategies with the changes in the environment to remain legitimate; however as the institutional changes become more extreme, organizations are unsure about legitimacy and effectiveness of strategic actions (Newman, 2000). Thus, we propose an inverted U-shaped relationship between pro-market reforms and organizational pursuit of new growth opportunities.

As emerging economies undergo institutional transition, the effects of pro-market reforms are felt most by firms that successfully operated in the pre-reform period and pursued strategies to profit from the lack of market supporting institutions. In the case of emerging markets such as India, business group affiliated firms were the prominent beneficiaries of weak institutional environment (Gaur & Delios, 2015; Kedia, Mukherjee, & Lahiri, 2006). Business groups are multi-entity organizational forms, which operate through extensive diversification (Khanna & Palepu, 2000). Such organizational structure puts group affiliated firms in a privileged position to identify and exploit new opportunities as they become available (Gaur, Kumar, & Singh, 2014; Manikandan & Ramachandran, 2015). At the same time, with the pro-market reforms, and the resulting elimination of institutional voids, scholars have questioned the underlying logic of diversification premium in emerging economies (Gaur & Delios, 2006). Thus we expect group affiliation and prior diversification to be important moderators of the relationship between pro-market reforms and pursuit of new growth opportunities.

We contribute to the literature on the effect of pro-market reforms on firm level outcomes by utilizing the institution-based view (Peng, 2003) to analyze the strategic choices of new investments for corporate expansion. While the extant literature has focused on the effect of reforms and institutional transition on the strategic choice of international expansion (Dau, 2012; Popli et al., 2017), our focus is on growth within domestic markets through investments in new projects. Given the size and importance of domestic markets in emerging economies such as China and India, it is important to understand the strategic choices that firms make in domestic markets when faced with institutional transition. In doing so, we help understand the mechanism underlying linear (Cuervo-Cazurra & Dau, 2009), as well as curvilinear relationships (Chari & Banalieva, 2015) between reforms and firm performance.

2. Theory and hypotheses

Organizations are embedded in the external context and the interaction between organizations and external institutions shapes the nature and outcome of economic activities (Wright et al., 2005). Such interactions become more important in environments in which the context of business activities keeps changing due to ongoing institutional transition. In such situations, institutional theory has emerged as one of the major frameworks to conceptualize the relationship between pro-market reforms and firm level outcomes.

Based on the tenets of new institutional economics and organization sociology, studies suggest that institutions provide basic framework for organizations to undertake rational as well as legitimate actions. Defining institutions as humanely devised constraints, North (1990) argues that institutional framework of a society serves as a constraint to regulate economic activities by setting up the rules of the game which exert efficiency based pressures on firm strategy (Peng, 2003). Organizational sociology, on the other hand, suggests that institutions are widely shared beliefs in society which signal legitimate activities resulting in normative pressure on organizations (Newman, 2000). Taken together, institutional context leads to efficiency and legitimacy considerations for organizations to survive and compete (Peng & Heath, 1996).

Corporate expansion is a fundamental element of organizational growth (Penrose, 1959). However, organizational growth is pursued within the gambit of institutional framework, industry context and resource considerations which may facilitate or constrain such growth (Peng & Heath, 1996). The adoption of pro-market reforms has transformed the institutional context in emerging economies through gradual reduction of government interference in economic activities and development of institutional mechanisms to support efficient market-based transactions (Chari & David, 2012; Peng, 2003; Popli et al., 2017). Such transformation from a planned economy to a market based economy is often undertaken in both gradual as well as radical manner depending on the specific aspects of institutions (Popli et al., 2017). How firms strategically respond to institutional change is a major topic of interest in strategy research (Newman, 2000; Peng & Heath, 1996).

To address this question, some scholars have focused on the degree of institutional change and its impact on the strategic responses of firms to the new institutional context. While some studies argue that firms undertake fast and pervasive change if the institutional prescriptions change dramatically, others predict for a rapid but repetitive change as it is difficult to choose appropriate strategic actions in the face of radical changes in the institutional context (Gaur, 2007). In fast changing environments, existing resources and capabilities may become obsolete and learning from prior experience may not provide future direction for performance enhancing strategy (Mukherjee, Gaur, & Datta, 2013; Newman, 2000). Therefore, although change in the institutional context may trigger adaptive organizational change, too much change in the institutional context actually inhibits radical organizational transformation.

The context of pro-market reforms includes both radical as well as gradual changes in the prevailing institutional environment. While the specific steps in the reform vary from country to country, there are many common characteristics of the reform process with respect to changes in the capital markets, labor markets and product markets. Changes in capital markets involve financial market liberalization, strengthening of the stock markets, and reforms in currency conversion. Changes in the labor markets involve policies to increase the talent pool and to ease labor mobility domestically as well as internationally. Product market reforms include freeing up the restrictions about entry and exit in different industries, and greater integration with the global economy through import, export and investment liberalization (Khanna & Palepu, 2000).

Together, these reforms open up several new opportunities of growth for the incumbent firms as well as new entrants. With the government's focus on earning foreign exchange in the early years of reform, there is great impetus on exports and foreign expansion of domestic enterprises. However, reforms also open up domestic markets, attracting foreign firms and forcing domestic incumbents to search for new sources of competitive advantage to remain competitive in the face of increased competition by the foreign firms. In such context, when the extent of reform is small in the early phases, firms are able to learn and adapt to such reforms to undertake strategic changes using their past