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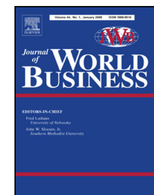

Contextualizing international learning: The moderating effects of mode of entry & subsidiary networks on the relationship between reforms & profitability

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ABSTRACT

This empirical paper studies how MNEs from developing and emerging markets may learn through their choice of entry mode and subsidiary network configuration, and use this knowledge to increase their responsiveness to pro-market reforms in their home market. The paper proposes that entry modes and network configurations that facilitate knowledge acquisition provide firms from developing countries an advantage when responding to such institutional changes. The analyses use data for the largest Latin American companies from 1989 to 2008. The findings provide evidence for a positive moderating effect of equity international joint ventures, international acquisitions, and subsidiary network centrality closeness on the relationship between reforms and profitability.

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1. Introduction

The global strategy literature has increasingly focused on the effect of pro-market reforms and other related institutional processes on the performance of companies from developing countries (e.g., Chari & Banalieva, 2014; Kumaraswamy, Mudambi, Saranga, & Tripathy, 2012). These reforms are defined as institutional processes and changes implemented by governments seeking to improve the operation of their local markets and consequently of domestic firms (Lora, 1997, 2001; Rodrik, 1996, 2006). Prior work has focused on how reforms affect different aspects of business performance, such as profitability, international diversification, innovation, entrepreneurship, and business group affiliation (e.g., Katrak, 2002; del Sol & Kogan, 2007; Khoury, Cuervo-Cazurra, Dau, 2014). However, arguments in the literature have been mixed on whether reforms and globalization are actually of benefit to local firms (e.g., Guillen, 2001; Mander & Goldsmith, 1996; Stiglitz, 2003). This suggests that other factors, such as the strategic choices that firms make, may help better explain whether firms are actually able to "activate" such potential benefits (e.g., Dau, 2013; Dau, 2016; Kumaraswamy et al., 2012).

On the other hand, the literature has examined the relationship between international learning, international diversification, and mode of entry (e.g., Barkema & Vermeulen, 1998), and how these in turn impact subsidiary performance (e.g., Zahra, Ireland, & Hitt, 2000). However, less attention has been devoted to how the knowledge that firms acquire through their choice of international modes of entry and subsidiary network configuration may affect their responsiveness to institutional changes in their home market of operation.

The current paper fills this gap in the literature by studying the moderating effects of an MNE's (multinational enterprise) mode of entry (e.g., Newburry & Zeira, 1997) and subsidiary network structure (e.g., Nell, Ambos, & Schlegelmilch, 2011) on the relationship between reforms and profitability of firms from countries characterized by marked institutional voids (Khanna & Palepu, 1997; McCarthy & Puffer, 2016). Building on the notion that firms may acquire valuable knowledge through their internationalization efforts that provide a competitive edge when responding to reforms and other institutional changes in their home market (e.g., Dau, 2013, 2016), the paper suggests that modes of entry and network configurations that facilitate access to international knowledge provide a greater boost in this respect. In particular, the arguments suggest that firms that internationalize via equity international joint ventures (in place of international wholly owned subsidiaries) and via international alliances (in place of

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international greenfield investments) are able to acquire business and institutional knowledge more quickly from international markets, giving them an edge when responding to institutional changes at home. Similarly, the tighter the concentration a firm has of its subsidiary network (i.e., centrality closeness), the easier it becomes to transfer knowledge acquired abroad to its headquarters, which in turn facilitates its responsiveness to institutional changes. The paper tests and finds support for these arguments using a panel of the largest companies in Latin America from 1989 to 2008.

This paper provides a number of contributions to the literature on contextualizing international business research (e.g., Von Glinow & Teagarden, 1988, 1990; Von Glinow, Teagarden, & Drost, 2002). It teases out the mechanisms whereby MNEs acquire knowledge across international contexts and transfer this knowledge across their network of subsidiaries. Building on the international business literature on international knowledge spillovers (e.g., Blomström & Kokko, 1998; Meyer & Sinani, 2009; Zahra et al., 2000), network theory (e.g., Anand, 2011; He & Wei, 2013; Nell et al., 2011), and entry mode (e.g., De Villa, Rajwani, & Lawton, 2015; Hennart & Slangen, 2015; Surdu & Mellahi, 2016), it describes how different modes of entry and network configurations can facilitate knowledge acquisition and transfer (c.f., Maekelburger, Schwens, & Kabst, 2012). Furthermore, it examines how firms may benefit from this knowledge acquired across international contexts when responding to institutional changes in their home market context. Building on the literature on institutions and emerging market firms (e.g., Aulakh & Kotabe, 2008; del Sol & Kogan, 2007) it studies how such companies may align their internationalization strategy with external institutional processes in their home market to enhance their performance in the face of institutional voids (c.f., Khanna & Palepu, 1997; McCarthy & Puffer, 2016). In studying the change of the institutional environment over time, the paper provides a dynamic element to the study of the context of international business, which is important given the calls in the literature for moving beyond more static concepts (e.g., Teagarden et al., 1995; Von Glinow & Shenkar, 1994). Finally, the paper contributes to the growing literature on institutions and firms (e.g., Hoskisson, Wright, Filatotchev, & Peng, 2013; Meyer, Estrin, Bhaumik, & Peng, 2009) by bringing new moderators into the discussion of whether reforms are favorable for firms and under which circumstances. The choice of mode of entry and subsidiary network configuration are key strategic decisions that MNEs make in their efforts across international contexts (Surdu & Mellahi, 2016) so understanding how they can interact with institutional changes can be a critical aspect for firms (Brouthers, 2013; Owens, Palmer, & Zueva-Owens, 2013). The arguments and findings of the paper provide meaningful implications for managers and policy-makers by helping to clarify the circumstances whereby reforms support the performance of local firms.

The remainder of the paper is organized as follows. The next section provides the theoretical development, leading up to the hypotheses. This is followed by a description of the methodology, results, and robustness tests. The final section provides a discussion and general conclusion for the paper.

2. Theoretical background and development

2.1. Pro-market reforms: learning domestically

Recent work has found evidence for the argument that pro-market reforms positively impact the profitability of developing-country companies, because such reforms expose firms to enhanced institutional and business knowledge (Cuervo-Cazurra & Dau, 2009a; Dau, 2013, 2016). This section provides a brief review of some of the key ideas of that work, as they provide the basis on which the arguments of this paper are developed. The coupled effect between market experiential knowledge and improved profitability occurs because pro-market reforms improve the functioning of the market and expand opportunities so firms are driven to increase their competitiveness, which in turn increases competition. Hence, firm profitability is enhanced when the firm gains market experiential knowledge, as it allows it to not only cope with but also thrive under new market conditions.

Market functioning is greatly improved with pro-market reforms when there are parallel efforts of reducing unnecessary regulations while reinforcing market oversight mechanisms (e.g., Frye & Shleifer, 1997; IMF, 2004). Deregulation frees the market to the forces of supply and demand. Instead of an artificial or subsidized price level by the state, a regulated market sets the price for goods and services. Price liberalization increases the opportunities available to firms, which allows them to augment their profitability. Market liberalization decreases bureaucracy and red tape that often make it difficult for a firm to develop new entrepreneurial undertakings and to be efficient in their operation. Once these reforms are in place, firms are able to expand both domestically and internationally and increase their profitability (c. f., IMF, 2004). Opportunities for firm international expansion through exports and multinationality can also be enhanced through liberalization of policies for trade and foreign direct investment.

Based on the literature on positive knowledge spillovers between firms (e.g., Blomström & Kokko, 1998; Meyer & Sinani, 2009), previous research has indicated that as competition intensifies after reforms, local firms benefit from the resulting knowledge spillovers (Luo & Wang, 2012; Xia, Ma, Lu, & Yiu, 2014). Pro-market reforms not only have a positive impact and increase competition for domestic firms, but also increase the presence and opportunities for foreign firms, which in turn increases the amount of competition in the market.

As foreign firms enter new markets, they tend to bring with them their sources of competitive advantage and advanced knowledge as they seek to succeed in those markets (Li, Li, & Shapiro, 2012), increase efficiency (Mudambi, 2008), receive favorable treatment from local governments (Huang, 2003; Li et al., 2012), and overcome the liability of foreignness (Luo, Zhao, Wang, & Xi, 2011; Zaheer, 1995). In order to compete with foreign entrants, domestic firms will have to increase their market knowledge and enhance their productivity, efficiency, and innovation (Buckley, Clegg, & Wang, 2007; Tian, 2007; Zhang, Li, Li, & Zhou, 2010). Therefore, even though increased opportunities that are created by reforms give the firms a path to increase their competitiveness, the increase in competition, both domestically and internationally, forces them to do so. The increase in competition compels domestic companies to study the manufacturing processes, marketing strategies and product designs of their rivals and hence acquire experiential business knowledge from their competitors (Caves, 1996; Elango & Pattnaik, 2013). This knowledge increase can be obtained by observation of the practices of rivals, activities such as reverse engineering, and knowledge carried by employee movements between firms (Li et al., 2012; Lu, 2000). Moreover, as foreign firms develop their supply chains and human capital in the host market, domestic companies can benefit from knowledge spillovers when acting as buyers or suppliers of the foreign firms, as well as through personnel turnover from the foreign to the domestic firms (Blomström & Kokko, 1998; Li, Chen, & Shapiro, 2010; Li et al., 2012).

As firms increase their business knowledge base they become more capable of increasing their domestic profitability but also of venturing out to increase their presence abroad (Luo & Wang,

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