



# Institutional distance and the quality of the headquarters–subsidiary relationship: The moderating role of the institutionalization of headquarters' practices in subsidiaries<sup>☆</sup>



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## ABSTRACT

Through the lens of the institutional theory, we developed and empirically tested a contingency theoretical framework that examines the effects of formal and informal institutional distances on the quality of the headquarters–subsidiary relationship, and how such effects are contextualized by internal institutionalization of headquarters' practices in subsidiaries of Chinese multinational enterprises (MNEs). Data were collected from both the headquarters of 297 Chinese MNEs and their respective subsidiaries. The results show that regulative and cultural distances are positively associated with the quality of the headquarters–subsidiary relationship, and that these positive relationships are stronger when subsidiaries institutionalize headquarters' practices to a higher degree. Theoretical and practical implications are highlighted in the paper.

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## 1. Introduction

A rich body of literature has examined various dimensions of the headquarters–subsidiary (HQ–Sub) relationship, most notably headquarters control (e.g., Chen, Paik, & Park, 2010) and subsidiary autonomy (e.g., Wang, Luo, Lu, Sun, & Maksimov, 2014), focusing on the locus of control and the amount of decision-making autonomy that a subsidiary may enjoy (Nohria & Ghoshal, 1994). However, an equally important dimension – the quality of the HQ–Sub relationship (Kostova, 1998), especially the determinants of quality of HQ–Sub relationship, remain largely unexplored. Johnston and Menguc (2007) defined the quality of the HQ–Sub relationship as a construct that consists of the assessments of four aspects within the HQ–Sub relationship, including the levels of communication effectiveness, commitment, mutual trust and

satisfaction between headquarters and subsidiary, and it is regarded as a source of competitive advantage that affects an MNE's performance (Kostova, 1998). Communication effectiveness refers to the extent to which there is open, continuous, and interactive communication in a relationship (Menon, Bharadwaj, & Howell, 1996); commitment implies a willingness to make short-term sacrifices to realize long term benefits from the relationship (Dwyer, Schurr, & Oh, 1987); mutual trust refers to the willingness to rely on a partner in whom one has confidence (Nell, Ambos, & Schlegelmilch, 2011); and satisfaction refers to the extent to which both partners in a relationship are satisfied (Smith & Barclay, 1997). Moreover, existing literature on the HQ–Sub relationship suggests that there is a lack of deep understanding of how social contextual embeddedness of headquarters and subsidiary affects the HQ–Sub relationship (Hoenen & Kostova, 2015). In particular, the existing literature has not adequately addressed how the difference between headquarters' and subsidiaries' institutional environments in home and host countries (i.e., institutional distance) influences the quality of the HQ–Sub relationship. Since the institutional environments in which the MNEs are embedded shape their understandings, values and leeway of action (Fidrmuc & Jacob, 2010; Salter & Sharp, 2001), the negligence of institutional

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variables in studying HQ-Sub relations may impede our understanding of how the quality of the HQ-Sub relationship is shaped in particular environments where the MNEs operate. Thus, it is important to incorporate a social context in HQ-Sub relationship research in order to obtain such contextualized knowledge (Hoenen & Kostova, 2015).

The rapid international expansion of MNEs from emerging economies like the Chinese MNEs, with a very distinct home country institutional environment, has attracted increasing attention from scholars (e.g., Luo, Xue, & Han, 2010; Peng, Sun, Pinkham, & Chen, 2009). The institutional theory contends that the institutional environments in which a firm operates significantly shape its structure and behavior (e.g., Peng, Wang, & Jiang, 2008; Scott, 1995); it is therefore regarded as a suitable theoretical lens in understanding the environment–organization relations. Given that the MNEs operate in multiple countries and face diverse external institutional environments (Kostova, Roth, & Dacin, 2008; Westney & Zaheer, 2001), the external institutions will directly affect the nature of the HQ-Sub relationship (Hoenen & Kostova, 2015). Despite the claim that institutions can influence the inter-organizational relationship (Eden & Miller, 2004; Kostova & Zaheer, 1999; Oliver, 1990; Rosenzweig & Singh, 1991), the theoretical development on the impacts of institutional environments on the HQ-Sub relationship in the existing literature remains scant, particularly in relation to the quality of the HQ-Sub relationship. Furthermore, the influence of MNEs' internal institutional environment (i.e., institutional environment formed within the organization with its own legitimacy requirement over time) (Selznick, 1957) has also been largely neglected, revealing a critical omission in our understanding of how the institutions influence the quality of the HQ-Sub relationship. In support of this view, researchers call for more studies on the role of institutional environments in the MNE context (Kostova et al., 2008), and how the HQ-Sub relationship is shaped by the social context in which the headquarters and subsidiary are embedded (Hoenen & Kostova, 2015).

Drawing on recent developments in institutional theory (Pache & Santos, 2010), our paper addresses this research gap by conceptualizing and empirically testing a theoretical framework to investigate the impacts of differences in institutional environments between home and host countries (i.e., institutional distance) on the quality of the HQ-Sub relationship. Moreover, from a contingency perspective, we also examine how the influence of institutional distance on the quality of the HQ-Sub relationship is contingent upon the subsidiary's internal legitimization process through institutionalization of headquarters' practices. We sought to show that an institutional-based approach can offer insightful analysis on how the MNEs' external and internal institutions affect the quality of the HQ-Sub relationship in Chinese MNEs.

We choose the Chinese MNEs as the empirical context for examining the issues under investigation for the following reasons. First, Chinese MNEs are early players in the international market (Child & Rodrigues, 2005; Cui & Jiang, 2009; Kang & Jiang, 2012), and they make outward foreign direct investment (FDI) with the aim of compensating their competitive disadvantages, such as their lack of sophisticated technology or advanced manufacturing know-how (Luo & Tung, 2007). Their motivations for outward FDI differ greatly from that of developed economy MNEs which generally aim for leveraging and exploiting their ownership-specific advantages in the international markets (Dunning, 1981; Lecraw, 1983). Such differences in motivations for outward FDI may lead to different dynamics between headquarters and subsidiaries in Chinese MNEs compared to those from developed economy MNEs. Second, China's outward FDI is heavily influenced by the state government (Deng, 2004; Luo et al., 2010), and it is

regarded as being a manifestation of 'soft power' (Brautigam & Tang, 2012), i.e., the ability to shape the preference of others through appeal and attraction of culture, value and diplomacy (Nye, 2004). This implies that the institutional environment is likely to have a significant impact on Chinese MNEs' outward FDI decisions (Buckley et al., 2007) and their HQ-Sub relationships. Third, China is one of the leading emerging economies in terms of FDI outflow (UNCTAD, 2013), with outward FDI in more than 170 countries (MOFCOM, 2013). The countries that host Chinese FDI range from the least-developed countries to the most-developed countries, and those countries' institutional environments differ significantly from one another and from that of China. This difference in institutions provides scholars with an ideal setting to study how MNEs' response to the differences in home- and host-country institutional environments shape the quality of MNEs' HQ-Sub relationships.

## 2. Theoretical framework

Institutions are defined as the 'rules of the game' that affect organizations as players (Peng, 2003), composed of formal (i.e., regulative pillar) and informal institutions (i.e., normative and cognitive pillars) (North, 1990; Scott, 1995). The formal institutions are manifested in regulative institutions, which refer to the rules and laws that exist to safeguard social stability and order (North, 1990). The informal institutions are captured by national culture, as national culture is closely related to the normative and cognitive institutional pillars (Eden & Miller, 2004). It has the normative aspect because social norms, values and beliefs are part of a culture's characteristics. It also has the cognitive aspect, since culture is defined as the 'collective programming of the mind that distinguishes one category of people from those of another category' (Hofstede & Bond, 1988, p. 6). In a given country, the formal and informal institutions determine socially acceptable patterns of organizational structures and practices (DiMaggio & Powell, 1983). In order to survive in a host country, firms must obtain external legitimacy by conforming to established institutional rules, such as business models, structures and practices (Kostova & Zaheer, 1999). Therefore, MNEs are subject to external institutional pressure, which refers to the various institutional demands for firms to conform in a given field that stem from differences in institutional environments (i.e., regulative and cultural distances) between home and host countries (Pache & Santos, 2010).

Existing studies on firms' response to institutional environments suggest that firms enact legitimization processes based on their interpretations of these institutional demands (Greenwood & Hinings, 1996; Lounsbury, 2001), and the way that firms respond to these institutional demands is determined by the nature of these demands and the degree of internal representation of these demands (Pache & Santos, 2010). The nature of the demand can exert pressure at an ideological or a functional level, where the ideological level demands prescribing which goals are legitimate to pursue, and the functional level demands requiring appropriate means and courses of action (DiMaggio & Powell, 1983; Oliver, 1991; Townley, 2002). The nature of the demand influences its negotiability, as the ideological level demand is related to the core system of values which is difficult to challenge and negotiate, whereas the functional level demand is related to the means and process, which becomes more flexible when it is challenged. Furthermore, the degree of internal representation, i.e., the extent to which organizational members adhere to and promote a given demand (Kim, Shin, Oh, & Jeong, 2007), also affects a firm's response to institutional demands, as the higher degree of internal representation receives more support and commitment from organizational members, and it is more likely to be acted upon

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