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Absorptive capacity development in Indonesian exporting firms: How do institutions matter?

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ABSTRACT

This paper addresses how firms from an emerging market characterized by a challenging and variable institutional environment learn about internationalizing. Building on the organizational learning and institutional literatures, and the concept of absorptive capacity (AC), and using a sample of Indonesian manufacturing-sector exporters we identify two dimensions of internationalization-related AC: international market and international strategic operation. Unlike previous literature, we find that indirect, or second-hand, experience contributes more than the firm's own experience to the development of international market AC. Furthermore, the second-hand experience feeds Indonesian manufacturing exporters' learning in both positive (e.g., buyers) and negative (e.g., suppliers and foreign multinationals in Indonesia) ways. In contrast, the development of international operation strategy AC appears to be driven internally, with minimal contribution from either first- or second-hand experience. We posit that these outcomes are influenced by the rapid and substantial changes in the domestic institutional environment faced by the Indonesian manufacturers.

1. Introduction

Firms learn and develop absorptive capacity about entering international markets in the context of their home environments. This study investigates the internationalization of firms from an emerging market: Indonesia, the world's fourth-largest country, in terms of population. Despite experiencing drastic changes in its institutional environment over several decades, Indonesia has retained its place in the group of fast-growing Asian nations. In the 1970s and 1980s, the Indonesian government espoused internationalization strategies that were focused first inward and then outward, leading to large swings with respect to foreign direct investment (inbound and outbound), importing, and exporting. In 2001, the country moved from a very centralized system to a fully decentralized one, which resulted in a sharp decline in the foreign investment that had constituted such an important economic base. Despite the regulatory turbulence, Indonesia has maintained economic growth above 5% during most of the past two decades. In this paper, we aim to understand how firms operating under such frequent and drastic institutional changes learn about entering international markets. Our study is based on the premise that learning encompasses both processes and outcomes (Dodgson, 1993). Thus, we focus on absorptive capacity, a concept that captures the process of knowledge acquisition along with the application of that knowledge (e.g. Easterby-Smith, Graca, Antonacopoulou, & Ferdinand, 2008; Nooteboom, 2000). Specifically, we use the Cohen and Levinthal (1990: 129) definition of absorptive capacity: "...the firm's ability to recognize the value of new, external information, assimilate and apply it to reach the organization's goals ...". Under the assumption that the external environment affects a firm's ability to develop its absorptive capacity, Indonesia's rapid and extreme institutional changes create an interesting context in which to explore how firms learn about the process of internationalization.

The development of successful cross-border operations requires firms to acquire knowledge about foreign markets; previous research has found that the ability to understand foreign market characteristics and conduct information exchange is associated with stronger internationalization performance (Jonsson & Lindbergh, 2010). Firms have various avenues for acquiring such knowledge, including both internal and external sources (Fletcher & Harris, 2012). In this study, we extend the literature by investigating how firms operating in a challenging institutional setting learn about entering international markets

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from both first- and second-hand experience, including both the firm's internal (first-hand, or direct experience) and external sources of learning (second-hand, or indirect experience).

Two theoretical perspectives are used to frame this study. Organizational learning theory (e.g., Levitt & March, 1988) argues that firms learn from both their own (first-hand) experience and the experience of others (second-hand). Institutional theory, on the other hand, focuses on the fit between the firm and its local environment, arguing that firms have incentive to conform to the norms of the various social groups in which they are embedded, such as professional associations and governments or authorities at the national, regional, and local levels (Scott & Meyer, 1991); complying with these institutional values is viewed as important for the firm's survival. Combining the organizational learning and institutional perspectives provides a foundation for understanding how firms learn about entering international markets.

2. Literature review and hypothesis development

The basic premise of institutional theory is that organizations require legitimacy to prosper. Firms experience normative pressure from various sources, including governments and industry associations; such groups define the operating norms and social proprieties that must be met in order for organizations to function in their environment (e.g., Zucker, 1987). Because the sources of normative pressure are functionally interrelated and, often, geographically remote (Scott & Meyer, 1991), the firm may gain legitimacy for operating in international markets as a by-product of complying with institutional requirements specific to those locations. Hence, for firms that operate internationally, a key challenge of entering a foreign market pertains to understanding its specific norms.

There are strong linkages between institutional theory and how a firm learns. Levitt and March (1988) maintain that three characteristics of institutions underpin organizational learning. First, action is driven by legitimacy. Firms aim to fit their situations to the environment. Second, organizations are path dependent, in that action is guided by previous processes and outcomes. Third, an organization moves toward its goals. Firms continuously compare the difference between their aspirations and their achievements, and institutional theory argues that, over time, organizations operating within a particular environment tend to develop similar characteristics and become isomorphic (DiMaggio & Powell, 1983) as they adapt to their common context. Under the assumption that a firm acquires knowledge based on both its own actions and the actions of other firms with which it deals, absorptive capacity is inherently affected by the firm's institutional environment.

The literature tends to view internationalization as a learning process (Autio, Sapienza, & Almeida, 2000; Forsgren, 2002; Johanson & Vahlne, 1977, 2003a, 2003b, 2009), and organizational learning research highlights that firms can learn from their own direct (first-hand) experience as well as the experience of others (Levitt & March, 1988; Tippins & Sohi, 2003), also known as indirect or second-hand experience. While the international business literature tends to emphasize learning based on first-hand experience (e.g., Blomstermo, Eriksson, Lindstrand, & Sharma, 2004; Eriksson, Johanson, Majkgard, & Sharma, 1997; Hadley & Wilson, 2003; Johanson & Vahlne, 2003a), stressing experiential knowledge, some authors explore the value of second-hand experience by acknowledging that firms' relationships can also offer learning potential. Tippins and Sohi (2003), for instance, argue that firms learn from others when the content of the new information relates to the firm's existing stock of knowledge. Eriksson and Chetty (2003) note that a firm lacking in experiential foreign market knowledge can generate absorptive capacity based on dyadic relationships with customers and related networks. Thus, it seems clear that second-hand experience also has a role to play in the context of how firms learn about internationalization.

However, the actual contribution of experience to the development of absorptive capacity has not been the focus of research to date. Previous quantitative studies have tended to focus on the measurement of absorptive capacity (e.g. Murovec & Prodan, 2009) or on specific, formal situations, such as international joint ventures (e.g., Ijose, 2012). In contrast, our focus is on the relative contributions of different types of experience to the development of absorptive capacity in the context of learning about entering international markets.

It is important to distinguish between first-hand and second-hand experience. Soosay and Hyland (2008) note that a firm's absorptive capacity and use of knowledge for decision making depends on its previous use of that knowledge, which implicitly represents first-hand or experiential knowledge. In the context of cooperation, Murovec and Prodan (2009) find that internally-generated innovation pushes the firm to develop its absorptive capacity, in order to be able to respond more effectively to the market, as compared to external drivers. Similarly, coping with a frequently-changing external environment, such as that faced by Indonesian firms, may mean that firms' own experience, developed in the context of their own operations, has greater utility than second-hand experience when undertaking important strategic decisions, including those pertaining to entering international markets. Based on the internationalization literature's support for the importance of experiential knowledge in the decision-making process regarding international market entry (Blomstermo et al., 2004; Eriksson & Chetty, 2003; Eriksson et al., 1997; Hadley & Wilson, 2003), we hypothesize:

Hypothesis 1. A firm's own experience provides a stronger contribution, relative to second-hand experience, to its absorptive capacity in the context of learning how to enter international markets.

Firms are social actors that link with various institutional players, developing relationships with buyers, suppliers, and others—both domestic and foreign. Laursen and Salter (2006) note that firms innovate by balancing their own knowledge with that gained externally via the expertise of others. Through engagement with a variety of players, including buyers and suppliers, firms have the potential to learn from these other actors (Parkhe, Wasserman, & Ralston, 2006). Furthermore, Laursen and Salter (2006) argue that the ability of firms to conduct broad and deep external searches allows them to transform learning into innovation.

Nonaka and Toyama (2002) maintain that knowledge created within a context and a collection of routines facilitates the creation of additional knowledge. Relationships between buyers and suppliers tend to be contextualized and have consistent patterns of communication, which may make them particularly effective at structuring the transfer of knowledge. For example, Schmitz and Knorringa (2000) find that, in business-to-business relationships, buyers with concerns about product quality tend to be willing to develop the capabilities of suppliers, to enable them to provide components of suitably high quality. In order to assure quality along the value chain, buyers develop policies within their organizations that are aimed at communicating effectively with suppliers and maintaining trust between the contractual partners. The relationship with buyers and suppliers allows firms to conduct joint learning to improve both parties' competitiveness (Chen, Lin, & Chang, 2009). Laursen and Salter (2006) argue that the need for radical innovation encourages firms to rely heavily on key sources in order to develop applicable knowledge. It seems fair to assume that internationalization represents such a situation of radical innovation for Indonesian firms, and that lead users and