Journal of World Business 50 (2015) 294–301

Contents lists available at ScienceDirect

Journal of World Business

journal homepage: www.elsevier.com/locate/jwb

Privatization, governance, and survival: MNE investments in private participation projects in emerging economies

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ARTICLE INFO

Article history:
Available online 27 October 2014

Keywords:
Privatization
Private participation projects
Nonmarket strategy
Governance structure

ABSTRACT

Multinational enterprises (MNEs) investing in infrastructure privatization projects in emerging economies – often known as private participation projects – face both market-based and nonmarket-based competition simultaneously. Integrating transaction cost economics, bargaining model, and the institution-based view, we examine the bargaining process between MNEs and host governments. Leveraging data from 113 emerging economies, we find that the survival of MNE investments is dependent on the bargaining outcomes between MNE and host governments around investment location, governance structure, and host governments' ownership of the private participation projects.

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1. Introduction

The trend of broad economic liberalization and reform in emerging economies around the world during the past few decades has presented new opportunities and challenges to investors. Many emerging economies have launched ambitious efforts to privatize their infrastructure industries and opened investment opportunities to multinational enterprises (MNEs), which are traditionally only available to state-owned enterprises (SOEs) (Henisz, Zelner, & Guillen, 2005; Ramamurti & Doh, 2004). Given the politically sensitive nature of private ownership in infrastructure development in emerging economies (Doh, Teegen, & Mudambi, 2004), the term "private participation projects" has been used by the World Bank to characterize these partially privatized projects. Private participation projects refer to projects that have substantial contributions from private (domestic or multinational) enterprises. Early privatization policies tended to discriminate against foreign investors and MNEs represented only a very small proportion of privatization activities (Bevan, Estrin, & Meyer, 2004; Wells & Gleason, 1995). However, multiple sector-level reforms are gradually increasing the legitimacy of institutions supporting foreign investments (Henisz & Zelner, 2005; Ramamurti, 2001) and driving MNEs to significantly increase investments into high-risk countries (Feinberg & Gupta, 2009). This research refines current understanding of MNE-host government interactions and provides guidance for privatization investments by exploring the process and outcomes of bargaining between MNEs and host governments.

As MNEs pursue market strategies to survive and compete across borders, they interact with host governments to induce favorable policies pertaining to market access, regulations of their subsidiaries, and taxation (Carney, Gedajlovic, & Yang, 2009; White, Hemphill, Joplin, & Marsh, 2014). Governments also pursue their own agendas, which then require firms to bargain with governments to reduce or eliminate unfavorable policies (Boddewyn, 2014; Ramamurti, 2000). In short, in addition to market factors, MNE governance and survival also depend on the social, political, and legal context within which it takes place—in other words, its nonmarket environment (Agarwal, 2001).

Privatization is a natural experiment to study how corporate governance mechanisms evolve and affect firm performance (Boubakri, Cosset, & Guedhami, 2005; Denis & McConnell, 2003; Meyer & Peng, 2005). Research on privatization in emerging economies has investigated the antecedents (i.e. institution-level, firm-level, and project-level factors) that influence the balance of state versus private ownership (Doh, 2000; Doh et al., 2004; Ramamurti, 1992), the effects of country characteristics (DeCastro & Uhlenbruck, 1997; Henisz et al., 2005; Ramamurti, 2003), the nature of privatization methods (Djankov, 1999; Megginson & Weiss, 1991), and the evolution of government ownership and

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http://dx.doi.org/10.1016/j.jwb.2014.10.006
1090-9516/Published by Elsevier Inc.

control in privatization (Inoue, Lazzarini, & Musacchio, 2013; Vaaler & Schrage, 2009). Our study extends previous research by exploring *nonmarket* strategies of MNEs participating in the privatization projects. Host governments and SOEs continue to play a major role in many privatized firms (Bortolotti & Faccio, 2009), resulting in diverse governance structures in private participation projects (Zahra, Ireland, Gutierrez, & Hitt, 2000). Endeavoring to acknowledge such diversity in privatization, our study addresses the following research questions: (1) What determines the MNE-host government bargaining outcomes in private participation projects? (2) How do the MNE-host government bargaining outcomes affect the survival of private participation projects?

Our study contributes to the literature on privatization in three ways. First, drawing from the obsolescing bargain model (Kobrin, 1987; Luo, 2001; Ramamurti, 2001), we recognize private investment decisions as consequences of bargaining between investors and host country governments. Henisz and Zelner (2005) direct future work to depict differences in decision-making processes among private investing firms. Doh et al. (2004) call for research identifying which factors contribute to the *success* and *failure* of privatization projects. In response to these calls, we link the MNE-host government bargaining model with the survival of MNE investments and explicitly compare the decision process and outcomes between MNEs and domestic firms. Second, governance structures are organizational frameworks that decide transaction relations (Williamson, 1985). We extend transaction cost economics (TCE) that has a historical emphasis on transactions between private entities (Hennart & Park, 1993) to analyze governance structures that resolve MNE-host government negotiations relations. We demonstrate how prevailing nonmarket factors play an important role in corporate governance in emerging economies. Third, we further integrate the institution-based view (Peng, Wang, & Jiang, 2008) with TCE and explore how governance structures in privatization projects are dependent on the characteristics of the private entities and the institutional environments in which they take place (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Filatotchev, Stephan, & Jindra, 2008; Hoskisson, Hitt, Johnson, & Grossman, 2002; Rediker & Seth, 1995). Drawing on a large database of 7101 private participation projects in 113 emerging economies around the world amassed by the World Bank, we empirically test the hypotheses.

2. MNE-host government bargaining

There is growing research on the relationship between host governments and MNEs and that bargaining affects firm strategic choices and outcomes. Host government intervention has traditionally been viewed as exogenous such that MNEs respond or adapt to that intervention, or seek to circumvent it (Doz, 1986; Dunning, 1980). More recently, studies recognize that the relationship between MNEs and host governments in emerging economies has become more cooperative (Dunning, 1998; Luo, 2001) and even co-evolutionary (Carney et al., 2009). As a result, nonmarket factors may present opportunities and added value to firms (Frynas, Mellahi, & Pigman, 2006; Oliver & Holzinger, 2008), especially in volatile emerging markets (White et al., 2014).

The obsolescing bargain model (Kobrin, 1987; Ramamurti, 2001) suggests that bargaining between investors and host governments comprises trade-offs and that MNE strategies represent the outcomes of such bargaining. MNE-host government interactions present both conflicts and mutuality of interests (Fagre & Wells, 1982; Kobrin, 1987; Luo, 2001; Vernon, 1971), which are influenced by resources brought by one party and demanded by the other and coercive power from both parties derived from economic and nonmarket pressures (Fagre & Wells, 1982; Kobrin, 1987). Ramamurti (2001) argues that MNE-host government negotiations are a dynamic, multi-party bargaining process and that MNE policies in emerging economies are transitional. He proposes that the bargaining power of MNEs has been strengthened and the power of host countries has been weakened due to the support for MNEs from multilateral institutions including the World Bank, the IMF, and the WTO.

Other studies have shown that government interference is especially pronounced in infrastructure-related sectors (Frynas et al., 2006; Henisz & Zelner, 2005; Wells & Gleason, 1995). Before privatization, the state had to satisfy multiple political claims in managing SOEs, which may result in significant deviation from market-based efficiency (Zahra et al., 2000). At the onset of privatization, this template may still be deeply embedded and the state may retain many practices that conflict with the management of a market system (Makhija, 2004). Moreover, privatization researchers note that deals in emerging economies are likely to include post-privatization conditions (DeCastro & Uhlenbruck, 1997). In structuring the process of market liberalization and private ownership in previously state-controlled sectors, host governments face a challenging range of options as they seek to balance political, social, and economic goals in determining the extent and pace of reform (Doh, 2000).

At the same time, MNEs also face important questions concerning their participation in privatization projects. MNEs' bargaining power can be derived from the theory of foreign direct investment (Buckley & Casson, 1976; Rugman, 1981). Equipped with technology, capital, and market-oriented managerial capacity that are often beyond the reach of host governments, MNEs may possess initial bargaining advantages (Kobrin, 1987). After the investment is made, MNE-host government conflicts are likely to arise over distribution of the investment gains and differences in objectives. MNEs face both market-based and nonmarket-based competition simultaneously and need expertise not only about the market environment, but also about the nonmarket forces of the host country (Li, Peng, & Macaulay, 2013). We argue that MNEs may adopt governance structures that help maintain bargaining power, execute nonmarket strategies, and reach bargaining results beneficial for both MNEs and host governments.

3. Political stability in the host country institutional environment

As "rules of the game," institutions promote economic exchange and coordination by creating order and reducing uncertainty (North, 1990; Williamson, 1985). The institution-based view provides an insightful perspective when explaining firm behavior in emerging economies (Meyer, Estrin, Bhaumik, & Peng, 2009; Peng et al., 2008; Shenkar & Von Glinow, 1994). Institutional instability in emerging economies has often led to disappointing results in privatization (Jiang & Peng, 2011; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). Research has recognized uncertainty in the institutional environment as constraints on firm choices (Argyres & Liebeskind, 1999). In privatization projects, factors such as the randomness of the market or the unpredictable discretion of policy increase uncertainty (Choi, Lee, & Kim, 1999). Different institutional environments have important implications not only on the design and implementation of privatization programs, but also on the strategic responses of MNEs that invest in these projects.

Nonmarket factors, especially the political interests and pressures, reflect the institutional environment of host countries and influence the location choice of MNEs (Bevan et al., 2004; Dunning, 1998; Rugman, 1981). Political instability may decrease the attractiveness of the host country. With competition among emerging economies for foreign investments increases, MNEs have