



# Legal system contingencies as determinants of political tie intensity by wholly owned foreign subsidiaries: Insights from the Philippines



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## ABSTRACT

How will managerial perceptions concerning specific dimensions of legal system uncertainty affect wholly owned foreign subsidiary (WOFS) political tie intensity? This study employs the institution-based view of international business strategy to explore how managerial perceptions of specific dimensions of legal system uncertainty – ex-ante commercial law inadequacy and ex-post judicial arbitrariness – will act as determinants of WOFS political tie intensity. Our analysis of 181 WOFSs in the Philippines suggests that managerial perceptions of ex-ante commercial law inadequacy and ex-post judicial arbitrariness, being two distinct dimensions of legal system uncertainty, are determinants of political tie intensity. We also find that the positive association between managerial perceptions of ex-ante commercial law inadequacy and the intensification of political ties grows stronger when a WOFS is committed to organizational adaptation of capabilities to the local context, while the positive association between managerial perceptions of ex-post judicial arbitrariness and the intensification of political ties grows stronger when a WOFS is engaged in strategically positioning operations in an emerging market environment.

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## 1. Introduction

Global institutional bodies such as the World Trade Organization and World Intellectual Property Organization have long been assisting governments to assimilate toward international standards for the purpose of enhancing certainty associated with the statutory governance of laws that often affect multinational enterprise (MNE) operations (Khoury & Peng, 2011; Peng, Wang, & Jiang, 2008; Teegen, Doh, & Vachani, 2004). However, despite this long-standing movement toward establishing a uniform system of global standards for the governance of laws (e.g., in protecting intellectual property rights), the application and enforcement of laws remain largely country specific and a product of local institutional norms (Luo, 2007; Peng, 2003).

Suppose that an MNE establishes a wholly owned foreign subsidiary (WOFS) in an emerging market where its managers perceive the legal environment to be marked by extreme

uncertainty concerning the context and application of laws. Emerging markets are often governed by laws that are ambiguous, underdeveloped and inconsistently implemented (Chung & Beamish, 2005; Luo, 2007, 2004). Thus, legal system uncertainty can be a serious concern for WOFSs due to their being structurally integrated and having greater control over operations than other forms of MNE foreign market entry modes (Kobrin, 1980; White, Hemphill, Joplin, & Marsh, 2014). WOFSs are therefore particularly vulnerable to legal system uncertainty because arbitrary application of laws and regulations that govern commercial transactions will materially affect their operations (Delios & Henisz, 2000; Henisz, 2004; Hoskisson, Eden, Lau, & Wright, 2000; Kobrin, 1980).

Accordingly, managerial perceptions of legal system uncertainty in a host-country will play a major role in the determination of nonmarket strategic initiatives undertaken by a WOFS. For instance, Kobrin (1980, 1978) has long argued that foreign direct investment decisions are primarily driven by a manager's ability to subjectively interpret risk in potential host-country environments. Hence, once invested in a host country, managerial perceptions associated with uncertain legal systems will often encourage WOFSs to find ways to strategically minimize the influence of host-country risk in order to safeguard their investments and enhance operational effectiveness (Boddewyn & Brewer, 1994; Li, 2004).

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One way to mitigate legal system uncertainty is for a WOFs to strategically develop informal political ties with key host country government actors, such as with administrative agencies and regulatory authorities (Acquaah, 2007; Peng & Luo, 2000). The development of informal political ties with government actors in the nonmarket arena can help a WOFs align its operations with its host country legal environment by providing critical access to information, resources, and favors that can be called upon during times of unpredictability (Li & Zhang, 2007; Park & Luo, 2001; Xin & Pearce, 1996). However, foreign subsidiaries often fail to invest the optimal amount of resources necessary to develop intensive political ties with key government actors because managers may not always accurately assess the level of uncertainty in a host-country legal environment (e.g., Henisz & Zelner, 2003).

With this notion in mind, research has yet to investigate how differences in managerial perceptions of host country legal system uncertainty affect the intensity of WOFs political ties. So far, empirical research has primarily investigated how the extent of political ties influence firm outcomes such as government assistance (Wei, Hou, Wang, & Wang, 2011), export orientation responsiveness (Chung, 2012), product innovation (Wang & Chung, 2013; Wu, 2011) and various types of performance (e.g., Acquaah, 2007; Dong, Li, & Tse, 2013; Li & Zhang, 2007; Peng & Luo, 2000). Fewer studies have empirically explored the determinants driving the extent of foreign subsidiary political ties in an emerging market environment (Hillman & Wan, 2005; Park & Luo, 2001). For example, Luo (2001) found that personal ties with key government actors had a positive impact on MNE-government relations in China. Yet, previous research has not addressed how variation in managerial assessment regarding the level of uncertainty within specific dimensions of the legal system, such as *ex-ante* commercial law inadequacy and *ex-post* judicial arbitrariness, will affect WOFs political tie intensity. Therefore, in this study we contribute to the international business literature by assessing how managerial perceptions concerning these two dimensions of legal system uncertainty affect the intensity of WOFs political ties.

Based on the research of Sun, Mellahi, and Thun (2010) and Danis, Chiaburu, and Lyles (2010), we define political tie intensity as the degree to which senior managers invest time and resources in developing and maintaining informal ties via personal networking and lobbying activities with government officials in the nonmarket arena. This multi-dimensional construct is unique to the extant literature because it goes beyond only measuring the extent of ties by also empirically considering the time spent by managers interacting with host country government actors. These are in essence boundary-spanning informal connections between managers of WOFs and government actors that may be “instrumental for obtaining... information, leads, advice or other potential resources” (Danis et al., 2010, p. 291). Thus, we argue that political tie intensity with host country government actors can be leveraged by managers of WOFs as a unique nonmarket strategic advantage. We suggest that this will be particularly the case when legal system uncertainty is perceived by managers to be high. However, legal system uncertainty is a multidimensional construct that exists within the overall framework of an institutional environment. Therefore, we attempt to further extend this conceptualization by arguing that a primary determinant of a WOFs’s political tie intensity is through a manager’s assessment concerning the level of uncertainty concerning specific dimensions of a host country’s legal system – namely *ex-ante* commercial law inadequacy and *ex-post* judicial arbitrariness.

Hence, we set-out to address and answer the following research question: *How will managerial perceptions concerning specific dimensions of legal system uncertainty affect WOFs political tie intensity?* We address this research question by employing the institution-based view of international business strategy

(hereinafter the institution-based view), which explains how foreign subsidiary strategies are driven by managerial perceptions concerning characteristics of institutions in an operating environment (Meyer, Estrin, Kumar Bhaumik, & Peng, 2009; Oliver, 1997; Peng, 2002). The institution-based view advocates that institutional frameworks signal to managers of WOFs which strategic decisions are suitable in a host country (Peng, 2002; Peng et al., 2008). These strategic decisions concern “rational choices” that managers may or may not exercise in order to mitigate adverse effects associated with formal institutions (Peng, Sun, Pinkham, & Chen, 2009, p. 67). Our research extends the institutional-based view by explaining how differences in managerial perceptions concerning institutional factors within particular dimensions of a host country’s legal system are subjective and will vary considerably (Luo, 2007). It is therefore our contention that the institution-based view can be employed to predict these relationships by focusing on how managers perceive uncertainty within specific dimensions of a host country legal system; and it is these perceptions that will drive manager strategic choices in the nonmarket environment (Peng et al., 2008).

However, we also consider how the moderating impact of two particular organizational capabilities – organizational adaptation (Luo, 2002) and strategic positioning (Griffith & Harvey, 2001) – affect the relationships between the assessment of legal system uncertainty and WOFs political tie intensity. *Organizational adaptation* “involves the extent to which a [foreign subsidiary] commits to building new [management] capabilities through learning from other organizations, creating new skills, or revitalizing existing skills in new situations...” (Luo, 2002, p. 48). *Strategic positioning* assesses the optimal use of current foreign subsidiary resources for exploring market opportunities in light of an uncertain external environment (Griffith & Harvey, 2001; Teece, Pisano, & Shuen, 1997). Given the importance of a WOFs’s commitment to organizational adaptation and engagement in strategic positioning in identifying and coping with institutional uncertainty, we expect these two organizational capabilities to play a major role in enhancing the relationship between perceived legal system uncertainty and political network intensity. This conceptualization is particularly important when considering these relationships from an institution-based view perspective in that “[t]reating institutions as independent variables, an institution-based view on business strategy... focuses on the dynamic interaction between institutions and organizations, and considers strategic choices as the outcome of such interaction...” (Peng, 2002, p. 253). Furthermore, the institution-based view offers significant power when considering why managerial perceptions of legal system uncertainty and the utilization of organizational capabilities in a nonmarket environment will influence the variation of political tie intensity between WOFs.

Altogether, our study makes the following contributions to the literature. First, we draw from the political ties (Acquaah, 2007; Li & Zhang, 2007; Peng & Luo, 2000; Park & Luo, 2001; Sun et al., 2010) and nonmarket strategy literatures (Boddeyn, 1988; Boddeyn & Brewer, 1994; Boddeyn & Doh, 2011) in developing a conceptual framework investigating the un-explored relationships between managerial perceptions of legal system uncertainty and WOFs political tie intensity. Second, we extend the institution-based view by theorizing and finding that managerial perceptions of two specific dimensions of legal system uncertainty – commercial law inadequacy (being an *ex-ante* form of legal system uncertainty) and judicial arbitrariness (being an *ex-post* form of legal system uncertainty) – will both influence a WOFs’s propensity to intensify political ties. We consider that these two specific dimensions of legal system uncertainty are complementary in nature and salient for a WOFs to intensify political ties with key government actors. Third, through the application of the

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