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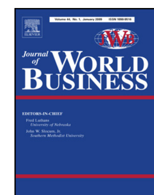

How do pro-market reforms impact firm profitability? The case of India under reform

Murali D.R. Chari [a,*], Elitsa R. Banalieva [b,1]

[a] Lally School of Management, Rensselaer Polytechnic Institute (RPI), 110 Eighth Street, Troy, NY 12180, USA
[b] D'Amore-McKim School of Business, Northeastern University, 360 Huntington Avenue, 315C Hayden Hall, Boston, MA 02115, USA

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ABSTRACT

A number of developing countries have enacted pro-market reforms to transform their economies from socialist to market economies. These reforms bring sweeping changes in the economic and competitive landscapes of these countries, with significant consequences for firm performance. We integrate Douglass North's theory of institutional change with gains from governing the economy through market forces relative to government control to theorize a U-shaped relationship between pro-market reforms and firm profitability. We also theorize that the U-shaped relationship will be shallower for foreign firms and top business group firms relative to independent firms. We test and find support for the theorized relationships in a large sample of 122,534 observations taken across 18,591 firms in India, as it has implemented pro-market reforms.

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1. Introduction

A number of countries around the world have enacted pro-market reforms in recent decades to transform their economies from socialist or command economies to more market-oriented ones (Cuervo-Cazurra & Dau, 2009; Peng & Heath, 1996). These reforms have brought sweeping changes to the economic and competitive landscapes in these countries, and their wide-ranging implications for improved economic development and enhanced firm productivity and profitability has attracted much scholarly attention (Bloom & van Reenen, 2010; Elango & Pattnaik, 2013; Hoskisson, Eden, Lau, & Wright, 2000; Khanna & Palepu, 2000a; Park, Li, & Tse, 2006; Peng, Wang, & Yi, 2008).[2] The effect of pro-market reforms on firm profitability is of particular interest to business because firm success is tied to firm profitability and understanding the effect of reforms on firm profitability can inform firm strategies in developing economies.

Moreover, the shift from a more socialist to a market-oriented economy implies a turn from government control toward the pursuit of profits guided by market forces governing (i.e., provide incentives for and direct) economic activity in the country (Ahlstrom, Young, Nair, & Law, 2003; Nelson & Sampat, 2001). Firm profitability, as a result, also represents an important harbinger of economic growth in these countries following reforms and thus holds particular interest for government policymakers as well. An understanding of the relationship between pro-market reforms and firm profitability can therefore help establish benchmarks to better understand and evaluate the process and outcomes of pro-market reforms and to suggest ways in which reforms can be expected to impact firm performance over time.

There are a limited number of studies that have examined the relationship between pro-market reforms in developing countries and firm profitability to date.[3] These studies have theorized a positive relationship between pro-market reforms and firm profitability owing to the reduction in agency costs of external monitoring that a shift to a market economy brings (Cuervo-Cazurra & Dau, 2009; Park et al., 2006). While the lower agency

* Corresponding author. Tel.: +1 518 276 3905.
E-mail addresses: charim2@rpi.edu (Murali D.R. Chari), e.banalieva@neu.edu (Elitsa R. Banalieva).
[1] Tel.: +1 617 373 4756.

[2] Our focus is on the implications of reforms for *firm* profitability. There is a stream of literature in development economics that examines the role of reforms for economic development at the national level (e.g., Baumol, Litan, & Schramm, 2007; Baumol & Strom, 2007; Naudé, 2011; Perkins, Radelet, Lindauer, & Block, 2012). While related in some ways, economic development is at a more macro level of analysis and hence different from the firm-level focus in this paper.

[3] Our interest here is on firm profitability. There are a few studies that have examined the sustainability or persistence of superior profits over time (e.g. Chacar, Newburry, & Vissa, 2010; Chari & David, 2012). Sustainability or persistence of superior profits over time is conceptually different and hence is not the focus of this study.

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costs of external monitoring in a market economy are rooted in and supported by a long and distinguished body of literature, including Smith (1776) and Hayek (1945), extant research has often downplayed the negative effects of transitioning the economy from one type of governance to the other (Young, Ahlstrom, Bruton, & Rubanik, 2011). Research on pro-market reform in India, China, Russia, and Poland shows that the transition takes time and can create a period of monitoring vacuum as the government steps away from its monitoring role even as the newly evolving market forces are not sufficiently strong to fill the gap (Frydman, Phelps, Rapaczynski, & Shleifer, 1993; Khanna & Palepu, 1999a; Qian, 1995). This monitoring vacuum, combined with large uncertainties associated with reforms during transition, implies significant negative effects on firm profitability which is at odds with the positive relationship posited in extant theory. Since, at their core, pro-market reforms are a process of transitioning the economy from one system of governance to another, the negative effects of the transition are integral to the relationship between pro-market reforms and firm profitability.

What is the relationship between pro-market reforms and firm profitability if one takes the negative effects of transition into account? In answering this, we integrate the important literatures on institutional change and economic governance to theorize first that the relationship between pro-market reforms and firm profitability is U-shaped, declining initially as reforms are initiated and rising subsequently as a greater complement of reform measures are enacted, and second that this U-shaped relationship differs across firms depending on their access to internal networks of relationships. We then test our theorized relationships with a large sample of over 18,000 firms from India—a developing economy that has enacted fairly recent and extensive pro-market reforms.

Our study contributes to theory and empirical evidence and has important implications for managers and policy makers. Briefly, the U-shaped relationship we theorize improves upon current theory by explicitly recognizing and incorporating the potential negative effects of transition that pro-market reforms entail. Second, we theorize how the U-shaped relationship differs across firms. Here we show that access to internal networks of relationships has both a beneficial and a harmful effect on firm profitability. Finally, we provide the first set of empirical findings on the relationship between pro-market reforms and firm profitability using data on all firms, rather than just elite ones, and observed right from reform initiation in the country. The recent changes in India provide a set of reforms that are distinct in some ways from those in China and other transition economies as they occurred in a more democratic and market-oriented economy (Nair, Ahlstrom, & Filer, 2007). Thus this paper complements work on pro-market reforms that has traditionally focused more on planned economies in transition (e.g., Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004) and answers calls for adding to our understanding of firm strategy, structure and performance in developing economies under reform (Peng, 2003; Young, Tsai, Wang, Liu, & Ahlstrom, 2014). This research further confirms that businesspeople and policymakers alike need to be aware that the transition from socialist governance to market governance is neither smooth nor immediate, and initial declines in firm profitability (and performance of the economy) should be expected and prepared for.

2. Theoretical model of pro-market reforms and firm profitability

2.1. Pro-market reforms and institutional change

Pro-market reforms refer to changes in laws and regulations intended to move an economy from a more socialist orientation, where economic activity is governed largely by government control, to a market economy where economic activity is governed largely by market forces. Pro-market reforms are enacted as part of a process with initial changes that are sufficiently important to signal a clear departure from prior economic policies, followed by subsequent changes that reinforce the initial ones (Ahluwalia, 2002; Fischer & Gelb, 1991; Kornai, 1986; Panagariya, 2008; Ramamurti, 2000). These reforms bring about sweeping changes that can drive the growth and development of the entire economy (for an overview, see Baumol & Strom, 2007; Naudé, 2011; Nelson, 2008). The theoretical model developed in this paper applies to such pro-market reforms rather than the deregulation of certain industries pursued in developed countries where the economy is already largely governed by market forces.

Douglass North's (1990) theory of institutions and institutional change provides a helpful framework to theorize the linkage of pro-market reforms and firm profitability. According to North (1990), formal rules (laws and regulations) that structure incentives and constrain choices, informal norms and conventions that extend, complement, and sometimes substitute for the formal institutions, and mechanisms used to measure violations and impose penalties to enforce the rules together form the institutional matrix which governs economic activity in a society.

Institutional matrices are important for economic activity and performance (including the performance of economic actors such as firms) because they provide stability for economic exchange by lowering uncertainty (Buckley, 2013; North, 1990). The institutional matrix of a socialist economy is significantly different from that of a market economy. In a socialist economy, the formal rules shaping entry and operation of businesses are restrictive and determined largely by the government, while in a market economy the formal rules are liberal and enable business activity to be guided largely by market forces (North, 1990). While governments, through regulatory agencies and courts, are ultimately responsible for monitoring and enforcing formal rules in both types of economies, there is a difference. Unlike in a market economy, in a socialist economy the various ex-ante restrictions on business activity lower the need for ex-post monitoring and enforcement. Specifically, restrictive rules in socialist economies such as those that require firms to seek government permission before they can enter product markets, raise capital, or expand manufacturing capacity, provide governments an opportunity to exercise ex-ante control over which firms enter, raise capital, and expand capacity, and thereby addresses some of the need for ex-post monitoring and enforcement (Hikino & Amsden, 1994; Sharma, 1999). Table 1 compares formal rules and enforcement in socialist and market economies.

Pro-market reforms, in effect, are policies that aim to change the institutional matrix of a more socialist oriented economy to that of a market economy by liberalizing the formal rules regarding business activity. Pro-market reforms, for example, involve liberalizing restrictive rules for entry such as those requiring firms to obtain licenses from the government to start businesses. Restrictive rules dampen competition and innovation by dissuading individuals with ideas for new products and processes from entering the market and challenging incumbent firms (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002; Svorny, 2000).[4] By liberalizing (i.e., relaxing) such restrictions on entry, pro-market reforms can contribute to greater competition and innovation.[5]

[4] As a parallel to the market entry barriers and their ill effects, see the work by Ogilvie (2004, 2011) on merchant guilds in Europe and their restriction of trade. We thank the senior editor for bringing this to our attention.

[5] For a detailed discussion of how innovation by firms drives economic growth and contributes to society see Ahlstrom (2010), Nelson (2008), McCloskey, 2013; Mokyr (1990, 2002).

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