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# The moderating role of local embeddedness on the performance of foreign and domestic firms in emerging markets

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ABSTRACT

This paper examines the impact of the firm's degree of local embeddedness on its performance in emerging markets using the World Bank's Enterprise Survey Manufacturing Sector Module data on 15,715 firms covering 78 emerging markets. We use the degree of localization of sourcing and sales to measure the degree of embeddedness in the host country market. We argue that since embeddedness brings the firm into closer interaction with local firms and institutions, the costs of embeddedness should be lower for local firms than for MNE subsidiaries, since local firms can be assumed to be better able to decipher local institutions. We find that both dimensions are subject to a reversed U-shaped function. That is, by extending the degree of local sales and local sourcing up to a certain percentage, a firm can realize positive performance growth by becoming more embedded into the emerging market, but beyond this point, the performance impact is negative. We also find that foreign firms involved in local sales seem to lose part of their ability to exploit their ownership advantages as compared to foreign firms that export their production.

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## 1. Introduction

The factors driving inward investment into emerging markets have been explored quite extensively in the international business literature (Barbopoulos, Marshall, MacInnes, & McColgan, 2013; Meyer & Nguyen, 2005). However, so far, there has not been much attention paid to the subsequent performance of foreign firms and their domestic counterparts in these markets. Previous research has confirmed the superiority of foreign firms (FFs) to domestic firms (DFs) in areas such as innovation, productivity and capabilities (Dunning & Lundan, 2008). Indeed, the governments of many emerging markets seek to attract FFs and incentivize them to invest in the country. This behavior is driven by the expectation of beneficial spillover effects that might occur when a FF enters an emerging market (Rugman & Verbeke, 1998; Wint & Williams, 2002). These spillover effects can be defined as increases in the productivity of domestic firms (DFs) that occur due to the entry or presence of FFs given that the FFs are not able to fully internalize the benefits they bring to the market (Javorcik, 2004; p. 607).

Indeed, FFs have incentives not to share their knowledge with local competitors and therefore to prevent spillovers (Javorcik, 2004). Research on the impact of FF entries on local innovation and productivity emphasizes that DFs mostly suffer from these entries if the host country is less developed. In general, this can be attributed to an increase of competition (Aitken & Harrison, 1999), a lack of knowledge concerning technological and managerial aspects (Dutz, 2007), limited access to capital (Beck, Demirgüç-Kunt, & Maksimovic, 2008), and an inappropriately qualified workforce (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2011).

Even so, superior firm specific advantages (FSAs) do not always allow the investing firm to outcompete DFs in less developed countries (Cuervo-Cazurra & Genc, 2008; Hennart, 2009; Holburn & Zelner, 2010). According to the eclectic or OLI paradigm, the ability of a firm to enter a foreign market successfully is not just based on its firm specific advantages, which are referred to as ownership- or O-advantages, but also on the location specific (L) and internalization (I) advantages (Dunning & Lundan, 2008). While it seems to be reasonable to assume that companies from developed countries are superior to emerging market companies in terms of their O-advantages, local firms may be superior in their ability to incorporate location specific advantages in their

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operations as well as to internalize or otherwise exploit market failures in their home countries.

This paper seeks to make two main contributions. First, conceptually we present an argument that links firm performance to firm-level decisions about the configuration of the value chain and macro-level contextual institutional variables. Specifically, we argue that investment motivation is a determinant of the degree of local embeddedness of foreign subsidiaries in terms of their upstream and downstream transactions, measured as local sourcing and local sales. We derive a $2 \times 2$ matrix that presents four different archetypes of embeddedness in the host country, and present a series of hypotheses on the performance implications of increasing embeddedness by distinguishing between the performance impact on foreign firms and domestic firms.

We argue that the performance implications of increasing embeddedness are different for foreign firms and domestic firms because higher levels of local embeddedness will make the subsidiary engage not only with the local economic environment, but also to interact more deeply with the institutional framework of the host country. While we would expect all firms to develop some routines for managing embeddedness in both upstream and downstream relationships, we argue that particularly in emerging host countries, the underlying institutional structure creates asymmetrical costs of embeddedness that are higher for the incoming foreign firms than for domestic firms. This we argue is in part responsible for the resilience of local firms, who may enjoy privileged access to a range of local inputs and have higher levels of political capital.

Our second contribution is empirical, as we test our hypotheses on a comprehensive dataset of 15,715 firms in 78 developing countries drawn from the World Bank's Enterprise Survey Manufacturing Sector Module. We perform extensive robustness checks on our results, which lends credence to our argument that the costs of embeddedness are relevant for both foreign and domestic firms, and that in addition to decisions on entry mode and governance of the foreign affiliate, strategic decisions that deserve more attention in future research concern the degree of local embeddedness of the investing firm.

The remainder of this paper is organized as follows: Next, the theoretical background of the interaction of firm specific advantages and the institutional environment of emerging markets will be presented. Thereafter, the need for a deeper embeddedness in the host country's institutional environment particularly for market seeking foreign firms is discussed. Based on this, the hypotheses are presented, followed by the empirical analysis. We conclude with a discussion of the results and limitations of the study.

## 2. Firm specific advantages and the institutional environment of emerging markets

The advantages of FFs over DFs in emerging markets are mostly derived from their firm specific advantages (see among others McGahan & Victer, 2009). These mainly consist of intangible assets that can be transferred to the FF's subsidiaries at low cost (Horstmann & Markusen, 1989; Teece, 1977). A FF that enters an emerging market tends to exploit its firm specific advantages in order to internalize the gains from foreign direct investment (FDI) entirely (Aitken & Harrison, 1999). The full internalization of the gains from FDI by the FF prevents positive spillover effects for local competitors. In the absence of positive spillover effects, it is likely that the presence of FFs will reduce the productivity of DFs. This is because the FFs draw demand from the DFs which forces the DFs to reduce their output and thereby to spread fix costs over the reduced production, resulting in a less favorable position on their average cost curve (Aghion, Blundell, & Griffith, 2009; Aitken & Harrison, 1999). If the FFs are additionally able to produce at lower marginal cost than local firms, for instance by exploiting their firm specific advantages, local firms can be forced to withdraw from the market entirely.

FFs thus pose a serious threat to DFs in emerging markets. But in order to outcompete their local competitors, FFs need to be able to exploit their firm specific advantages. This gives rise to the question if the exploitation can be hindered by external factors in a way that DFs can remain competitive. Based on the OLI paradigm, these factors might be embedded in the location-specific factors, or they might be related to the internalization advantages (Dunning & Lundan, 2008). The location-specific factors in emerging markets distinguish themselves in many ways from developed countries (Busnaina & Woodall, 2015). The majority of these countries are characterized by rather instable institutional environments resulting in inefficient or even missing market mechanisms (Cuervo-Cazurra & Genc, 2008; Peng & Heath, 1996), increasing the liability of foreignness for FFs (Eden & Miller, 2004).

The institutional environment provides the structure for economic exchange (North, 1990; p. 34). The underdeveloped

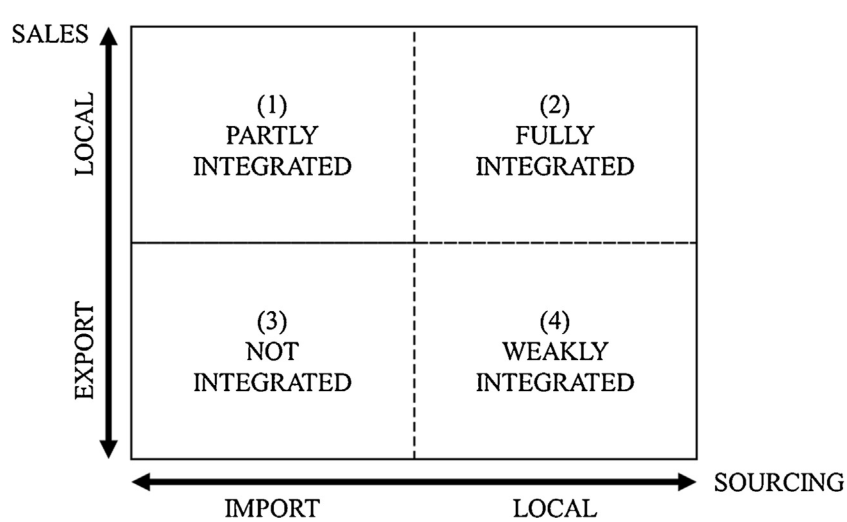


**Fig. 1.** Local Integration Matrix.

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