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The impact of institutional impediments and information and knowledge exchange on SMEs' investments in international business relationships

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ABSTRACT

This paper investigates the impact of institutional impediments and of knowledge and information exchange in international business relationships on small and medium-sized enterprises (SMEs) specific investments in international business relationships and the outcome of such investments on the performance of SMEs. Using a sample of 255 internationalising SMEs, we develop and test three hypotheses with the linear structural relations (LISREL) model. The analysis shows that institutional impediments and the exchange of knowledge and information in business relationships lead to increased relationship specific investments (RSIs). Furthermore, such investment results in increased performance for the internationalising SME. Research commonly uses micro or macro properties of institutions to explain how institutional differences affect international business; however, limited research has been devoted to investigate how institutional differences, experienced through interaction in business relationships, affect the business relationship. This paper helps to close this gap by showing the effects of institutional differences on a relational level.

1. Introduction

A significant development within the broad internationalisation trend has been the increasingly active role played by small and medium-sized enterprises (SMEs), which has attracted the interest of a large number of international business researchers (e.g., Chetty, Eriksson, & Lindbergh, 2006; Lu & Beamish, 2001; Oviatt & McDougall, 1994; Zhou, Wu, & Luo, 2007). Internationalisation offers opportunities for growth and enhanced performance for SMEs. To realise these opportunities, SMEs often need to make capital investments in international business relationships (Blankenburg Holm, Eriksson, & Johanson, 1999). SMEs generally have limited financial and managerial resources (Buckley, 1999); consequently, it is particularly important to investigate the antecedents of the relationship specific investments (RSIs) of SMEs, as well as the performance outcomes of those investments (Jarillo, 1989; Oviatt & McDougall, 1994). Relationship specific investments are defined as investments not easily redeployed in other relationships (Klein, Crawford, & Alchian, 1978; Subramani & Venkatraman, 2003; Williamson, 1985).[2]

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[2] The terms "relationship specific investment" and "transaction specific investments" both originate from Transaction Cost Economics (e.g. Klein et al., 1978; Williamson, 1985). Because we are studying relationships we use the term relationship specific investments. Similar use is found in the works of, e.g. Joskow (1987), Richardson (1993), Miwa and Ramseyer (2000), and Verwaal and Donkers, 2002.

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Because most RSI studies have been conducted in a domestic market setting, scant empirical attention has been given to the investigation of RSI in cross-cultural exchange relationships (see Blankenburg Holm, Eriksson, & Johansson, 1996; Skarmeas, Katsikeas, & Schlegelmilch, 2002, for notable exceptions). Although increased globalisation has resulted in numerous interfirm partnerships across national borders, our understanding of antecedents and outcomes of RSI in an international context remains limited (Skarmeas et al., 2002).

The uncertainty of engaging in international business is well established in the international business literature (e.g., Johanson & Vahlne, 1977). For instance, foreign institutional environments may not be easily interpreted by a firm (Pfeffer & Salancik, 1978). We also know that foreign firms have a disadvantage compared with local firms in terms of understanding the local context and the specific aspects of conducting business in that particular market (Barkema, Bell, & Pennings, 1996; Hymer, 1976; Zaheer, 1995). Therefore, the acquisition of appropriate knowledge and information is fundamental to successful market entry abroad, particularly in resource-constrained SMEs (e.g., Craig & Douglas, 1996). However, entering foreign markets may reduce the efficiency of information flow between the firm and the local business partner. Based on the notion that differences in the institutional environment and exchange of knowledge and information are major challenges that internationalising SMEs need to face (e.g., Oviatt & McDougall, 1994), this study focuses on these aspects and the purpose is to investigate their effects on the RSIs of internationalising SMEs as well as the performance outcomes of those investments.

Conducting business internationally means that firms engage in transactions in countries that are more or less different from their domestic markets. Countries may differ in their regulations regarding quality standards for products and in their norms and values (i.e., what is socially accepted business behaviour). Regulations, norms, and values are parts of a country's institutions (Kostova & Zaheer, 1999; North, 1990; Scott, 1995). Economic institutional theory defines institutions as constraints devised by people to shape human interaction (North, 1990, 2005). Institutions create a governance structure in which organisations perform activities (Williamson, 1985), embody and interpret institutions, and act accordingly. Thus, *macro* level institutional constraints affect a firm's decision making on a *micro* level (e.g., Scott, 1995). To complement the macro and micro perspectives of institutional constraints, we suggest a socio-economic approach that emanates from the assumption that the market is a social arena where economic activity is embedded in social networks (cf. Blau, 1964; Granovetter, 1985). According to this approach, firms are considered participants in internationalisation processes, which occur through relationships with other actors (i.e., other firms). To differentiate the socio-economic approach from the macro and micro perspectives of institutions, we use the term *institutional impediments* to refer to how institutional constraints relate to managerial cognition and relational-level business transactions. More specifically, this term refers to the situation in which the internationalising SME perceives local institutions to be obstacles when conducting business with a foreign business partner.

The acquisition of appropriate knowledge and information is considered fundamental for attaining international business success (e.g., Craig & Douglas, 1996; Liesch & Knight, 1999; Sharma & Blomstermo, 2003). Researchers have emphasised the impact of business relationships on the acquisition of knowledge and information for internationalising firms (Majkgård & Sharma, 1998; Sharma & Johanson, 1987), especially for resource-constrained SMEs with limited possibilities of acquiring information and knowledge in the marketplace (Liesch & Knight, 1999). However, international business relationships may reduce the efficiency of knowledge exchange because there are fewer opportunities for face-to-face interaction. Despite the acknowledged relevance of local institutions and efficient knowledge and information exchange to international business relationships, little is known about the impact of these issues on the RSIs of internationalising SMEs.

More specifically, the purpose of this paper is to investigate how institutional impediments and the extent of knowledge and information exchange in foreign business relationships affect the RSIs of internationalising SMEs and the performance outcomes of such investments. We thereby expect to contribute to the knowledge about value creation in international business relationships which has been advocated by, for example Lu and Beamish (2001). Furthermore, while previous studies have shown how buyers benefit in business exchanges it is less clear what conditions improve the performance of supplying firms (Dyer, 1996; Kotabe, Martin, & Domato, 2003). Hence, by focusing on supplying SMEs, we can help close this gap in the research.

Previous research on internationalising SMEs has mainly examined the time of entry, geographical scope, and entry mode (e.g., Crick & Jones, 2000; Lu & Beamish, 2001; Oviatt & McDougall, 1994; Zahra, Ireland, & Hitt, 2000). Thus, the focus has been on discrete steps made by internationalising SMEs rather than on business activities within international business relationships. By applying a socio-economic approach, we join the growing research stream of the international relational exchange perspective, which advocates the study of international business relationships as a means of understanding the internationalisation of firms (e.g., Blankenburg Holm et al., 1996; Chetty et al., 2006; Johanson & Mattsson, 1988; Liesch et al., 2002; Toyne, 1989; Turnbull, 1987). The basic assumption is that SMEs, through business exchange with foreign business partners, will be exposed to relevant problems and opportunities (Shenkar, 2001).

We use the term *internationalising SME* to denote an SME that conducts business in a foreign country and the term *business relationship* to represent an ongoing exchange relationship between the internationalising SME and a foreign business partner. The ongoing business is well under way, thus exchange of resources (e.g., product and/or services) has already taken place (Chetty et al., 2006). The business partner could be a distributor in a foreign country; hence, the internationalising firm is considered a supplying firm.

This paper begins with a discussion of international relational exchange and RSI. It is followed by a development of the primary hypothesised effects of RSI on the performance of internationalising SMEs and the effects of institutional