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Institutions, resources, and internationalization of emerging economy firms

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ABSTRACT

An important step in the internationalization process of emerging economy firms is the shift from exports to foreign direct investment (FDI). We integrate the resource- and institution-based views to suggest that firms that can use unique institutional advantages are more likely to make this shift. We test these arguments with a longitudinal sample of 28,563 firm-year observations (1989–2005). We found that firms that are affiliated with a business group, have more firm- and group-level international experience, have more technological and marketing resources, and operate in service industries are more likely to shift from exports to FDI.

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1. Introduction

The number of emerging economy (EE) firms expanding into international markets has grown exponentially in recent years, usually through exports (Aulakh, Kotabe, & Teegan, 2000; Yiu, Lau, & Bruton, 2007) although increasingly through foreign direct investment (FDI) (Luo & Tung, 2007). This strategic change, shifting from international operations based primarily on exports to a high-commitment method (FDI), is notable for firms in general (Barkema & Drogendijk, 2007) but for EE firms undergoing accelerated internationalization in particular (Mathews & Zander, 2007). The literature provides limited insights into which factors might induce such a strategic shift though.

As two distinct strategies of internationalization, exports and FDI exhibit different motivations, resource requirements, cost structures, risks, and consequences. Exporting is a low risk strategy for operating in international markets. It requires fewer resources and can be easily reversed. In contrast, FDI demands a greater commitment of resources (McDougall & Oviatt, 2000) and usually cannot be easily reversed. This makes it far more risky as well as more promising, in terms of its high potential returns (Lu & Beamish, 2001). The strategic shift from an international operating strategy based on exports to one that combines FDI with exports represents a major change in the firm's international commitment (Barkema & Drogendijk, 2007) and involves several challenges. A natural question thus emerges: Which factors enable EE firms to make this strategic change? In this study, we adopt a multi-theoretical approach, integrating the resource-based view (RBV) and institution-based view (IBV), to address this question, together with empirical evidence gathered from a large, novel panel data set that describes firms from the second largest EE, namely, India.

We contribute to the literature in three ways. First, by integrating the RBV and IBV, we provide a useful theoretical framework for analyzing the internationalization process by EE firms. Emerging economy firms may suffer weak resource bases in terms of traditional resources (Hitt, Dacin, Levitas, Arregle, & Borza, 2000). However, they often compensate for this weakness by using non-traditional, network-based resources that arise from the unique institutional and industrial characteristics of the environment in which these firms are embedded (Cuervo-Cazurra & Genc, 2008; Elango & Pattnaik, 2007). Outward FDI offers a means to escape the weak home country institutional environment (Witt & Lewin, 2007) for many EE firms. The institutional evolution that characterizes many EEs has led to rapid transformation in the competitiveness of certain key industries, such as business process outsourcing (BPO), in India (Peng, Wang, & Jiang, 2008). The quick rise to global dominance of these EE industries is largely attributable to the liberalization of industrial policies, including vast private and foreign participation. Noting these complex linkages among resources, institutions, and industries, we offer an inclusive, integrative theoretical framework for studying EE firm internationalization (Contractor, Kumar, & Kundu, 2007; Yamakawa, Peng, & Deeds, 2008).

Second, this study offers a clearer understanding of the antecedents of the change from exports to FDI. The stages model of firm internationalization suggests that internationalization

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typically occurs in a set of steps, from licensing to exporting to FDI (Johanson & Vahlne, 1977). Each step has different requirements and reflects a different set of strategic choices. An organization thus learns from each form of internationalization and moves to the next more complex form over time as it establishes a critical mass of knowledge and discovers new opportunities. The stages model is extensively studied, but it has not previously been applied to the shift from exports to FDI. We thus conceptualize internationalization as a "package" of international operating strategies, which the firm uses to increase its commitment to internationalization (Benito, Petersen, & Welch, 2009).

Third, with our unique study context, we help augment understanding of the stages model. Strategic change literature recognizes the importance of resources as enablers of strategic change. In an EE context, a firm's resources are constrained, and the institutional environment is less structured than in a mature economy. We need to analyze what enables firms to change from one strategy to another (Bruton, Ahlstrom, & Han-Lin, 2010). Situating our study in an emerging market context enables us to investigate this theoretical issue. Several scholars similarly have suggested that EE markets provide laboratory settings for effective tests of new theoretical insights and arguments (Wright, Filatotchev, Hoskisson, & Peng, 2005).

In contrast, most research on EEs has focused on developed economy firms entering EEs or domestic competition within EEs (Hoskisson, Eden, Lau, & Wright, 2000). Research pertaining to internationalization by EE firms offers deeper insights on the factors that affect EE firm exports (Aulakh et al., 2000; Filatotchev, Liu, Buck, & Wright, 2009) or FDI (Buckley et al., 2007; Yiu et al., 2007) but do not address the strategic change between them. Hitt, Tihanyi, Miller, and Connelley (2006), in a review of international diversification literature, note that studies of EE firms' internationalization would add value to international management research. We respond to this call and seek to develop a better understanding of factors effecting change in a firm's international operating strategy.

2. Theory and hypotheses

2.1. Background

Multi-theoretic approaches can be used to examine complex strategic choices, such as those related to firm internationalization in emerging markets (Yamakawa et al., 2008). For example, the RBV and IBV, both which appear in prior work that seeks to explain the strategic behavior of EE firms (Meyer, Estrin, Bhaumik, & Peng, 2009; Peng et al., 2008) likely interact. It is often difficult to compartmentalize the effects of resources versus institutions (Meyer et al., 2009). Accordingly, we develop our theory for this research by integrating the RBV and IBV.

The RBV asserts that firm-specific heterogeneity, in terms of resources and capabilities, determines firms' strategic choices (Barney, 1991), including those pertaining to international business operations. Resources and ownership-specific advantages are important for the internationalization of any firm (Tallman & Fladmoe-Lindquist, 2002). We argue that the way in which EE firms rely on their resources differs from that used by developed economy firms. Because EE firms often lack the traditional resources used to overcome the liability of foreignness, they turn to different types of resources, such as an ethnic customer base, cheap labor, or a dominant position in their home markets.

Using the RBV as a theoretical lens, Miller, Thomas, Eden, and Hitt (2008) argue that EE firms use their ethnic identity to survive in foreign markets. The prevalence of ethnically similar customers and competitors acts as a source of motivation and a basis for developing rare and inimitable resources to support EE firms' internationalization into developed economies. Ghymn (1980) demonstrates that Korean construction companies use domestic manpower for their FDI operations in Middle Eastern countries; similarly, Indian software companies make extensive use of their domestic manpower in their international operations—a notion that is virtually unheard of in the context of developed economy firms. Operating in difficult home country environments also improves EE firms' capabilities to manage in conditions of scarcity (Cuervo-Cazurra & Genc, 2008; del Sol & Kogan, 2007). For example, their production know-how emerges from unique capabilities in labor-intensive, small-scale manufacturing, and their marketing know-how reflects their ability to serve specialized, niche market segments, such as small expatriate ethnic communities (Wells, 1983).

Furthermore, unlike their counterparts from developed markets, EE firms use internationalization to gain competitive advantage in both foreign and domestic markets. While developed market firms tend to exploit their ownership-specific advantages to gain competitive advantages in foreign markets, EE firms develop and acquire new capabilities as they expand internationally (Aulakh, 2007). These newly acquired capabilities, along with their existing resources, help them compete in foreign markets and in their domestic markets (Kumaraswamy, Mudambi, Saranga, & Tripathy, 2012). Although firm resources are critical for both types of internationalizing firms, a key difference pertains to how they acquire and use those resources. Because FDI requires far more resources than exporting, EE firms in possession of greater firm resources are better equipped to shift from exports to FDI.

According to the IBV, institutions have the greatest effect on firm strategy and performance (Peng et al., 2008). Well-developed institutions enable firms to conduct business more efficiently using the market; underdeveloped institutions create higher transaction costs and make market-based exchanges less efficient. Although EEs are often characterized by weak institutions (Hoskisson et al., 2000; Wright et al., 2005), in many cases those institutions also are undergoing substantial reforms, which alter the nature of competition (Hoskisson et al., 2000). We posit that the (generally weak) nature of EE institutions and their modern changes produce institution-based advantages and stronger motivation for firms to commit greater resources to their international operations. There are three salient points.

First, some EE firms actively seek to escape stifling regulatory constraints at home or overcome negative country-of-origin effects and acquire legitimacy in international markets by investing abroad (Gaur & Kumar, 2010). Others view their home experience as a valuable resource to be exploited in other, similar foreign markets (Niosi & Tschang, 2009). For example, Cuervo-Cazurra and Genc (2008) show that EE multinationals enjoy a competitive advantage over their developed economy counterparts when they seek to enter and operate in other EEs because they have gained experience with operating in environments characterized with underdeveloped institutions and difficult governance conditions. Buckley et al. (2007) also note that Chinese FDI gets attracted, rather than deterred, by political risk, perhaps explaining the huge Chinese investments in many African nations marred by political instability.

Second, several EE industries (e.g. telecom, retail, insurance) historically have experienced minimal competition, particularly from foreign players. Institutional reforms are opening these industries to foreign players, exposing the domestic players to a higher degree of competition (Hoskisson et al., 2000). Higher industry competition through greater foreign participation may drive some EE firms to expand into international markets with more commitment, in search of new markets and to avoid clashes

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