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Legal Family and Infrastructure Voids as Drivers of Regulated Physical Infrastructure Firms' Exposure to Governmental Discretion

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ABSTRACT

Firms operating in regulated physical infrastructure industries such as electricity, water or telecommunications do not always avoid the risks associated with governmental discretion when choosing a foreign country to invest in. We develop a theoretical framework based on the organizational capability view to account for the boundary conditions of this risk-seeking behavior: countries with a similar legal system as the one of the home country and with high infrastructure voids. An empirical analysis using panel data on the international expansion of Spanish listed firms from 1986 to 2008 confirmed our hypotheses.

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1. Introduction

Recent research has shown that firms are heterogeneous in their attitudes toward governmental discretion (Alcantara and Mitsuhashi, 2012; García-Canal and Guillén, 2008; Henisz and Macher, 2004; Holburn and Zelner, 2010). By governmental discretion we mean the degree to which governments and regulators can unilaterally alter the conditions under which a firm carries out its activities in a country, i.e. "the rules of the game", potentially damaging the profitability of its investments (Henisz, 2000). The conventional wisdom states that firms should stay away from countries where governmental discretion is high to avoid being worse off due to unexpected changes in the rules of the game (Henisz, 2000; Henisz and Delios, 2001). Yet, recent evidence shows that not all firms avoid the exposure to governmental discretion. Most of this evidence comes from firms from regulated physical infrastructure industries (García-Canal and Guillén, 2008; Holburn and Zelner, 2010; Jiménez et al., 2014), although the evidence coming from these industries is not conclusive. For instance, Henisz (2002) and Henisz and Zelner (2001) found that governmental discretion deters investments in the telecommunications and electricity industries. Due to this mixed empirical evidence, more research is needed to identify the boundary conditions of this willingness to be exposed to governmental discretion by firms from regulated physical infrastructure industries.

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To fill this gap in the literature, in this paper we build a theoretical framework based on the organizational capability view (Amit and Schoemaker, 1993; Ethiraj et al., 2005; Madhok, 1997) aimed at explaining which factors increase the odds of a regulated physical infrastructure firm (RPIF) being exposed to governmental discretion. We argue that the willingness of RPIFs to invest in countries with governmental discretion increases in countries having both a legal system from the same family as the one of the home country and infrastructure voids. We consider regulated physical infrastructure industries to be those that were highly regulated in the past due to natural monopoly considerations (Bel and Fageda, 2013; Dorigoni and Portatadino, 2009; Ramamurti and Doh, 2004) and that, despite being affected by liberalization and deregulation processes around the world, entry for newcomers still requires acquiring a company owning one of the limited licenses available to operate in the industry or being awarded a new license or contract, usually through a competitive bid (Bonardi, 2004). We argue that, thanks to the political capabilities developed in the home country, these firms are less vulnerable to governmental discretion than firms from other industries. However, these capabilities are not equally fungible across countries. Our results show that countries with discretionary host governments, belonging to the same legal family as the one of the home country, and with high infrastructure voids provide the most suitable scenario for applying the RPIFs' accumulated political capabilities. In fact, we argue and provide evidence that when these two conditions are present in a country with governmental discretion, it is more likely that a RPIF will invest there than in a country without governmental discretion.

We test our hypotheses in a sample of Spanish listed companies that invested abroad during the 1986–2008 period. Companies from emerging countries are traditionally less deterred by underdeveloped institutions when they expand abroad (Cuervo-Cazurra and Genc, 2008; Cuervo-Cazurra and Genc, 2011). For this reason, using data from a country with stronger institutions, as Spain is, has the advantage of a more precise analysis of the attitudes to governmental discretion by firms from regulated physical infrastructure industries as compared to firms from the remaining industries. In addition, focusing in just one country allows us to control for the institutional environment in the home country.

2. An organizational capability view of the relationship between governmental discretion and location choice

Foreign direct investment (FDI) is a process in which firms combine their firm-specific resources and capabilities developed at home (brands, technologies, know-how and so on) with local resources that facilitate the exploitation of the former in the host market and/or contribute to the overall development of the firm's resource set (Hennart, 2009; Madhok, 1997). Managing these transfers and combinations of resources and capabilities is a critical driver of success in the internationalization process. However, this is not an easy task, as the firm has to adapt to different idiosyncrasies specific to each country. For this reason, the ability to manage these idiosyncrasies is, per se, a firm-specific organizational capability that can generate rents (Henisz, 2003) or that can help firms extract rents from their other resources in adverse environments (Lawton and Rajwani, 2011; Oliver and Holzinger, 2008).

Governmental discretion is one of the most important institutional idiosyncrasies a firm must take into account when expanding abroad. When exposed to this discretion, the profitability of a firm's foreign investments can be damaged due to unexpected changes in taxation, pricing or the conditions for profit repatriation (Henisz and Williamsom, 1999). Thus, avoiding countries with discretionary governments could be the natural behavior for most firms, irrespective of their industry, according to the results of previous research (Delios and Henisz, 2003; Duanmu, 2012; Guler and Guillén, 2010; Henisz, 2002; Henisz and Delios, 2001; Henisz and Macher, 2004; Henisz and Zelner, 2001).

However, avoiding these countries is not the only option firms have when dealing with governmental discretion abroad. Companies have an alternative, i.e. managing this instability by using the knowledge and skills accumulated at home from their interaction with governments and regulators or, generally speaking, using their political capabilities. Political capabilities are part of the set of organizational capabilities of a firm. Consistent with the organizational capability branch of the resource-based view (RBV) (Amit and Schoemaker, 1993; Ethiraj et al., 2005; Madhok, 1997), we distinguish between political resources and political capabilities. Lawton et al. (2013) classify political resources at three levels: human (e.g. employees or directors with governmental or regulatory experience), structural (e.g. a specific unit for dealing with politicians and regulators) and network (e.g. social capital that can be mobilized by the organization). Political capabilities are the routines and organizational processes through which political resources are deployed to put in practice a firm's corporate political activities (Lawton et al., 2013).

Knowledge is one of the main building blocks of political capabilities. Holburn and Zelner (2010) argued that firms develop this sort of knowledge either through organizational learning or via cognitive imprinting processes. In the first case, firms learn from their own experience of dealing with governments and regulators (learning by doing). In the latter case, "as a result of shared experiences, home-country managers develop mental models—simplified representations of reality—which they then use to interpret the environment and guide their actions under conditions of uncertainty" (Holburn and Zelner, 2010: 1293).

Recent research shows that firms having political capabilities may use them to obtain favorable entry conditions in countries with discretionary governments (García-Canal and Guillén, 2008; Holburn and Zelner, 2010; Jiménez, 2010), to obtain first mover advantages (Frynas et al., 2006) and/or to exercise lobbying activities (Lawton and Rajwani, 2011). All of these research efforts have contributed to the development of an organizational/political capability view of international expansion (Lawton et al., 2013) that offers a brand new perspective to analyzing the relationship between governmental discretion and FDI. The underlying hypothesis of this perspective is that firms accumulate expertise and capabilities related to dealing with governments and regulators in their home country that can be exploited and developed abroad.

Concurring with this organizational capability view, Cuervo-Cazurra and Genc (2008) showed that firms from developing countries are able to invest more in countries with underdeveloped institutions than firms from developed countries, as they are used to dealing with this instability at home. For the specific case of RPIFs, Henisz (2003) and Bonardi (2004) argued that these firms develop political capabilities because of their frequent interaction with politicians and regulators in their home country.

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