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Internationalization and innovation performance of emerging market enterprises: The role of host-country institutional development

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ABSTRACT

We examine how host-country institutional development influences innovation performance of internationalized emerging market enterprises (EMEs). Our panel-data analysis of Chinese EMEs shows that although host-country institutional development on average enhances innovation performance of the parent, such effects are more pronounced for EMEs with strong absorptive capacity and for those diversifying into a larger number of countries. Interestingly, EMEs with a higher level of state ownership gain more when entering countries with a lower level of institutional development. Our findings offer insights regarding how latecomer EMEs should configure their portfolio of subsidiaries in order to enhance innovation performance of their parent.

1. Introduction

Emerging market enterprises (EMEs) are increasingly venturing into foreign countries (Buckley et al., 2007; Wang, Hong, Kafouros, & Boateng, 2012; Wang, Hong, Kafouros, & Wright, 2012). Unlike firms from developed countries, EMEs operate in environments characterized by under-developed institutions that constrain the development of internal capabilities for innovation (Cuervo-Cazurra, 2008; Luo & Tung, 2007). Extant research suggests that firms originating from weak institutional settings expand overseas to seek more efficient institutions (Luo, Xue, & Han, 2010; Yamakawa, Peng, & Deeds, 2008) that may enable them to enhance their innovation performance and global competitiveness. Evolutionary theories of the multinational enterprise (MNE) suggest that knowledge and assets accessed and assimilated from foreign locations enrich the firm's knowledge bases which can lead to enhanced innovation performance (Birkinshaw & Hood, 1998; Kogut & Zander, 1993). Nevertheless, these studies have focused on the gains accrued at the subsidiary level and, therefore, as a result, we know very little about *whether* and *how* host-country institutional development affects the innovation performance of the parent of the internationalizing EME. This research gap is important because even though the patents for the parent company may come from innovations generated both at home and through knowledge acquisition from foreign subsidiaries, the role of the latter is often assumed away. From a strategic management point of view, accounting for the role of host-country institutional development may enable a more nuanced interpretation about where and how EMEs derive capabilities enabling them to innovate despite their weak internal R&D capabilities and unfavorable home-country institutional environment. Building on theories of institution and innovation, we examine how the level of host-country institutional development (via EME's portfolio of subsidiaries) influences innovation at home in addition to any unique home-based innovations and further examine how firm-specific idiosyncrasies (i.e. level of state ownership and absorptive capacity) and internationalization strategies (i.e. the geographic diversity of foreign locations and joint ventures vs wholly owned subsidiaries entry mode) affect this relationship. We propose that these contingencies may be particularly valuable in explaining which EMEs benefit from operating within well-developed foreign

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institutions. Our study, therefore, contributes to theories on internationalization and innovation in several ways.

First, prior research suggests that well-developed host-country institutions can help EMEs nurture innovation by providing factor inputs and innovation intermediaries and by reducing transaction costs (e.g., Wang, Yi, Kafouros, & Yan, 2015). On the other hand, many EMEs are not used to operate in such environments, and therefore, may be less able to exploit the associated benefits and may have to implement costly and disruptive organizational changes. So theory does not clearly predict when and how the level of institutional development in the host countries influences the innovation outcomes of the internationalizing EME. We, therefore, argue that not all internationalized EMEs benefit equally from well-developed institutions in the host country but instead this depends on the level of state ownership and more importantly on whether EMEs' ownership type matches the level of host-country institutional development.

Second, previous studies show that host-country institutions can be a source of competitive advantage for international ventures (Kim & Hoskisson, 2010), enabling firms to outperform competitors that remain at home. However, we argue that as firms differ in their abilities to internalize and benefit from host-country institutional advantages, only EMEs that possess stronger absorptive capacity can reap such institutional benefits and enhance their innovation performance. Our study thus differs from prior studies that examine whether absorptive capacity enables firms to benefit from external knowledge by testing the effects of absorptive capacity in assimilating the advantages host-countries' institutions offer to the innovation performance of internationalized EMEs.

Third, extant research provides mix findings about whether internationalized firms can benefit from geographical diversification of their subsidiaries (Hitt, Hoskisson, & Kim, 1997). We explain that a greater geographic reach allow firms to get access to a larger set of different types of innovation-supporting institutions, and empirically demonstrate that the effects of institutional development of the host country on innovation performance are stronger for EMEs who choose a broad instead of a narrow set of countries when they venture abroad. We thus extend prior theorizing by proposing that the differential effects of internationalization on innovation performance can be explained not only by the host-country level of institutional development, but also by differences in the geographic diversity of a firm's overseas subsidiaries.

Fourth, prior studies suggest that entry modes influence how foreign firms learn from foreign markets, innovate and transfer technology back home (e.g., Hoskisson, Wright, Filatotchev, & Peng, 2013; Yamakawa et al., 2008). However, research rarely examines how entry mode choices shape the effects of host-countries' institutions on the innovation performance of the internationalizing firm. Our study fills this gap by proposing that having a portfolio of joint venture (JV) alliances or wholly owned subsidiaries (WOS) influences differently this effect. This conceptualization advances the premise that the ability to exploit host-country institutional advantages depends on internationalization entry decisions, thus bringing the literatures on institutions, entry mode choice and innovation under a more comprehensive framework.

China is a particularly suitable context for this study not only because many Chinese firms have improved their position in the global battle for technological leadership but also because the country has catapulted in the world's third place of outward FDI with an estimated US$101billion in 2013 (WIR, 2014) expanding into countries with heterogeneous institutional environments (Cui & Jiang, 2009). To test our hypotheses, we explore the internationalization of 599 Chinese manufacturing firms (with established portfolios of foreign subsidiaries in diverse geographical locations) through a longitudinal study of 4067 firm-year observations for the period 2000–2010. Our findings demonstrate how host-country institutions positively influence the innovation performance of the parent and how firm-specific idiosyncrasies and internationalization strategies influence this relationship. The findings of the study also have implications for how managers of internationalizing EMEs can exploit institutional advantages of the host country and enhance innovation performance.

2. Theoretical background and hypotheses

Innovation depends on the company's capability to learn and integrate diverse knowledge and resources from multiple countries (Hitt et al., 1997; Yamakawa et al., 2008). International expansion, then, serves as a 'springboard' for developing organizational learning and acquiring innovative capabilities (Luo & Tung, 2007). Institutions on the other hand, commonly defined as "the rules of game" (North, 1990), influence firms' innovation structures and processes as well as the availability and cost of innovation inputs (Jackson & Deeg, 2008). A well-functioning and well-developed institutional environment may stimulate innovation by providing what firms cannot produce individually and by allowing firms to get access to various factors and innovation intermediaries, and build innovation-enhancing relationships (e.g., inter-firm alliances and research collaborations). Although globalization has accelerated in the past three decades, national innovation and institution systems differ in terms of, for example, government policies, regulations, education and research in universities, among others. These differences affect the quality and quantity of inputs and the demand for outputs of innovation and, therefore, the availability of technologies, know-how and intangible assets in a given location. Hence, because international differences in institutional development still persist (Hoskisson et al., 2013), the innovation-enhancing effects of internationalization may vary depending on the locations in which the firm's portfolio of subsidiaries operates.

In this study we expect that a host country's level of institutional development to affect the parent EME's innovation performance through its effects on the portfolio of the firm's subsidiaries. The following section, therefore, explains how subsidiaries enhance their learning and knowhow while operating abroad and how they transfer this back to the parent in order to develop innovations.

2.1. Knowledge flows from subsidiaries to the parent

MNEs from emerging markets tend to locate their subsidiaries in countries where institutional setups allow for increased opportunity for learning and technological knowledge-sourcing (Dunning, 1998; Kotabe, Dunlap-Hinkler, Parente, & Mishra, 2007). Each of these subsidiaries may help them access a unique set of advantages and resources tied to particular countries (Hitt et al., 1997; Kafouros, Buckley, & Clegg, 2012) and increase the likelihood of developing novel technological combinations (Jacobides, Knudsen, & Augier, 2006). Furthermore, in well-developed host-country institutional environments, foreign subsidiaries can access, recruit and/or collaborate with high-qualified and experienced local talent (i.e. scientists, designers and engineers) which can enhance the firm's innovation performance (Florida, 1997; Tung, 2007). In addition, because countries with well-endowed institutional settings are also characterized by dynamic and competitive local business environments they compel foreign subsidiaries to continuously upgrade their capabilities and keep up with the competition to ensure future survival and growth (Birkinshaw & Hood, 1998; Wan, 2005).