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How do sub-national institutional constraints impact foreign firm performance?

Xiaoying Li[a,*], Laixiang Sun[b]

[a] Keele Management School, Keele University, Staffordshire, ST5 5BG, United Kingdom, United Kingdom
[b] Department of Geographical Science, University of Maryland, MD 20742, United States

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ABSTRACT

This paper examines the impact of sub-national institutions on the performance of foreign firms in China. Building on institutional theory, we envisage that the negative effect of sub-national institutional constraints is moderated by firm size and age, entry mode, and market orientation. Our hypotheses are tested on a large-firm-level dataset of about 29,000 foreign firms in 120 cities in China within the period of 1999–2005. We find that firm size and age both have a diminishing positive impact on foreign firm performance; moreover, there is a U-shaped relationship between firm age and foreign firm performance in cities with higher level institutional constraints. We also find that joint ventures help mitigate the negative impact of sub-national institutional constraints on foreign firm performance when the level of institutional constraints is higher.

1. Introduction

Great attention has been devoted to the influence of institutional characteristics of host countries on the behaviours of multinational enterprises (MNE) and their subsidiaries. Within this stream of research, many studies focus on how the host countries' institutional environment affects the strategic choices of multinational subsidiaries regarding aspects such as location choice, entry mode choice, organization structure, choice of technology, capital and labor staffing, and sequence of investment (e.g., Brouthers, Brouthers, & Werner, 2008; Chan, Isobe, & Makino, 2008; Gaur and Lu, 2007; Henisz & Delios, 2001; Henisz, 2000; Luo, 2001; Meyer, 2001; Meyer, Estrin, Bhaumik, & Peng, 2009; Rodriguez, Uhlenbruck, & Eden, 2005). However, less scholarship has linked institutional characteristics to subsidiary-level performance (Henisz & Swaminathan, 2008). Some existing studies examine the roles of entry strategies in the survival of new foreign firms (Brouthers, Brouthers and Werner, 2003; Gaur & Lu, 2007; Miller & Eden, 2006). Others studies focus on the relationship between the institutional environment of host countries and the performance of established foreign subsidiaries (Chan et al., 2008; Gaur & Lu, 2007; Henisz, 2000; Kostova & Zaheer, 1999). However, very few of them investigate the types, behaviours, strategies, or characteristics of foreign firms that best facilitate performance with the institutional variations.

Moreover, little attention has been paid to the institutional variations within a host country; instead, most of the existing studies adopt a cross-country approach, with a focus on subsidiaries of MNEs from a specific home country, mostly the U.S. or Japan, operating in foreign countries. By identifying cross-country difference and assuming homogeneity within a country, this line of research can inform the practice of MNEs from specific home countries. The element that is largely neglected, however, is the impact of institutions on the performance of foreign firms operating in a specific host country. Just as institutions are not homogeneous across countries, homogeneity cannot be assumed within a country employing the same political and economic system; instead, there is significant subnational spatial heterogeneity (Beugelsdijk & Mudambi, 2013). In recognition of the importance of variations within a country, Meyer and Nguyen (2005) examine the impact of sub-national institutions on the entry mode choice of foreign firms in Vietnam. In a more recent study, Chan, Makino, and Isobe (2010) examine the extent to which sub-national regions can explain foreign affiliate performance in the U.S. and China, and they find that the sub-national region is significant in explaining foreign affiliate performance. Their results also suggest that sub-national differences are more critical to the explanation of firm performance in emerging economies than they are to that of developed economies. However, much remains to be

* Corresponding author.
E-mail addresses: x.li@keele.ac.uk (X. Li), lsun123@umd.edu (L. Sun).

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known about how sub-national institutions impact the performance of foreign firms.

This paper intends to offer, to the best of our knowledge, the first study investigating the impact of the level of sub-national institutional development on the performance of foreign firms in the largest emerging economy, namely, China. We define the level of sub-national institutional development as the extent to which the political and economic institutions in a sub-national region are developed and are favourable to foreign firms. This study pays a particular attention to the interaction effects of sub-national institutions and firm size, firm age, ownership type, and market focus on foreign firm performance. We choose China as the empirical setting of this study for several reasons. First, China's economy has been growing rapidly over the last two decades; China is now the largest recipient of foreign investment in the world (UNCTAD, 2010). Second, China features a one-party political monopoly; democracy and transparency are not integral to the Chinese political and economic system. Over the last three decades, China has gone through a major economic transition process; however, weaknesses in formal and informal institutions remain major obstacles to successful business. Third, the lack of sound institutions, together with imbalance of economic policy and development between different regions, enforces the diversified institutional environment across regions in China, which permits the exploration of implications of institutional variation within a country. These institutional constraints found in different locations suggest important performance implications for foreign firms. Theoretically, we adopt an integrative perspective of institutional theory and resource-based view, following Meyer et al. (2009), Meyer and Peng (2005), Peng (2003), Wright, Filatotchev, Hoskisson and Peng (2005), and Yamakawa, Peng, and Dees (2008).

Our hypotheses are tested on a large sample of foreign firms (numbering 29,065) located in 120 cities in China during the period of 1999–2005. In total, we have collected 128,461 firm-year observations. Our results indicate that there is a negative relationship between sub-national institutional constraints and foreign firm performance. We also find that, as hypothesized, joint ownership with local partner(s) dampens the negative relationship and that firm size and age have a U-shaped relationship with performance. Our hypothesis on the relationship between market-orientation and performance is not supported.

This study contributes to the literature in multiple ways. It enriches institutional theory by providing evidence of the relationship between institutional constraints and firm performance and the moderating effects of firm behaviours and characteristics on this relationship. It fills an important niche in the literature of international business studies by systematically examining the adaptation of foreign firms to diverse sub-national institutional environment in a large emerging economy. It provides evidence of the effectiveness of previous studies regarding the impact of institutional environment on entry mode choice and location choice of foreign firms.

2. Theory and hypothesis development

2.1. Sub-national institutions and foreign firm performance

Institutions are widely defined by "the rules of game," or more formally, "the humanly devised constraints that structure human interaction" (North, 1990). Specifically, institutions are multidimensional constructs encompassing many types of country-specific political, economic, and social characteristics. Such characteristics originate from the economic and political systems regarding the extent to which a country is governed by rule of law, the effectiveness and efficiency of the country's court system, outright or de facto expropriation, enforcement of contracts between the focal firm and its local partners, violation of intellectual property rights, and so forth (Henisz, 2000; Uhlenbruck, Meyer, & Hitt, 2003).

Recent theoretical work has integrated an institutional perspective with the analysis of business strategies (e.g., Dacin, Goldstein, & Scott, 2002; Oliver, 1997; Peng, 2003) and international business (e.g., Dunning & Lundan, 2008; Mudambi & Navarra, 2002; Ramamurti, 2003) by incorporating theoretical advances in institutional economics and sociology into strategy and international business research. Empirically, existing studies have found that institutions significantly shape the strategy and performance of firms (Chan et al., 2008; Henisz & Delios, 2001; Henisz & Swaminathan, 2008; Henisz, 2000; Wright et al., 2005). Formal institutions (such as the legal framework) and informal institutions (such as the practices of law enforcement) shape the transaction costs in pertinent markets and, consequently, investors' strategic choices and firms' performance (Meyer, 2001). Moreover, institutions influence the evolution of resources and capabilities (Meyer & Nguyen, 2005). For instance, networking competences are mostly developed in countries where transactions are usually based on relationships and networks (Kock & Guillen, 2001; Meyer & Nguyen, 2005; Peng & Heath, 1996). The institutional environment thus shapes the key parameters determining foreign firms' strategic choices and performance.

Coinciding with the rise of emerging economies in the global economy, scholars are increasingly turning their attention to these countries (Henisz & Swaminathan, 2008; Peng & Pleggenkuhle-Miles, 2009). The salience of institutions is more evident for MNEs operating in emerging economies, where institutions differ significantly from those in developed economies and are experiencing rapid changes. In fact, there has been increasing acknowledgement that the institutional context of emerging economies influences foreign investors' strategic choices (Meyer, 2001; Meyer et al., 2009). However, most of the existing studies limit themselves to the variations between national institutions.

Institutions not only vary between countries, but also within countries (Chan et al., 2010; Du, Lu, & Tao, 2008; Beugelsdijk & Mudambi, 2013; Luo, 2001; Meyer & Nguyen, 2005; Wright et al., 2005). The variations of the sub-national institutional environment within a country can be very vast, especially in an emerging economy. A typical emerging economy has gone through major economic transition, while weaknesses in the institutions remain major obstacles to business (Meyer & Nguyen, 2005). More importantly, liberalization has been implemented unevenly in this type of environment (Meyer & Nguyen, 2005), which leads to huge differences in economic and institutional development within the country. For instance, tax rates attract the FDI inflow in special economic zones in Chinese cities. Meanwhile, decentralization of power from the central government to local governments has seen a shift from national control to regional regulation (Luo, 2007). As a result, sub-national level governments have secured increasing power by manoeuvring economic policies in their regions (Luo, 2007). The uneven economic development and liberalization, increasing power at regional level and differences in implementing policies at sub-national level lead to huge variations in economic and political institutions at sub-national level in an emerging economy. These within country variations in economic and political institutions not only affects the volume and entry modes of FDI inflows (e.g., Du et al., 2008; Meyer & Nguyen, 2005), but also the costs of doing business in different regions (Chan et al., 2010; Meyer & Nguyen, 2005) and thus the profitability of engaging in business activities in these regions.

The development of sub-national economic institutions varies within a host country (Chan et al., 2010; Chung & Alcácer, 2002). As discussed above, in a typical emerging economy, economic