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# A double-edged sword? The moderating effects of control on firm capabilities and institutional distance in explaining foreign affiliate performance

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### ABSTRACT

By drawing from the internalisation and institutional theories, as well as the organisational capability perspective, the paper analyses the moderating effects of parent control over foreign affiliates in relation to firm capabilities and institutional distance and their performance effects. These relationships are explored in the context of new MNEs from Poland as a mid-range emerging economy, for which ownership choices constitute critical decisions given their early stage of internationalisation. Our findings show that while firm capabilities drive foreign affiliate performance, the increase of parent control limits this beneficial effect, suggesting the potential occurrence of organisational inertia and reduction of learning in foreign markets. On the contrary, we also find partial evidence that the increase of parent control reduces the negative effect of institutional distance computed based on the Mahalanobis formula. Accordingly, the study suggests a certain ambiguity of parent control in affecting affiliate performance.

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## 1. Introduction

The rise of multinational enterprises (MNEs) and the proliferation of their internationalisation strategies, particularly in the form of foreign direct investment (FDI), has resulted in a vast literature examining strategic decisions, among which ownership modes of foreign affiliates and their determinants have been an influential issue (Agarwal & Ramaswami, 1992; Cui & Jiang, 2010; Erramilli & Rao, 1993; Gomes-Casseres, 1989; Kaynak, Demirbag, & Tatoglu, 2007; López-Duarte & García-Canal, 2002; Meyer, Estrin, Bhaumik, & Peng, 2009). Indeed, corporate governance of the headquarters–subsidiary relationship constitutes an integral part of the strategic fit between the firm and its external environment (Filatotchev, Jackson, & Nakajima, 2013; Hoskisson, Wright, Filatotchev, & Peng, 2013). A part of the studies centred around foreign market entry modes has focused upon foreign affiliate performance and its determinants (Brouthers & Nakos, 2004; Brouthers, Brouthers, & Werner, 1999; Brouthers, Brouthers, & Werner, 2008; Chan, Isobe, & Makino, 2008).

Apart from exogenous influences on foreign expansion success at firm- and host country-level, it has been argued that the entry mode itself, with ownership as the manifestation of parent firm control over foreign market operations, is one of the important drivers of performance in foreign markets (Beamish & Lee, 2003; Gaur & Lu, 2007; Kim & Gray, 2008). Control can be defined as authority over decision making (Driscoll & Paliwoda, 1997; Hill, Hwang, & Kim, 1990), which allows firms to secure essential inputs to production, co-ordinate activities, ensure end products quality, and influence logistics and marketing activities for the product. Moreover, it enables the firm to identify more precisely the expectations of the market adapt the offering accordingly (Anderson & Gatignon 1986). Not least, firms choose a given organisational structure to minimise transaction costs and to maximise long term risk-adjusted efficiency (Anderson & Gatignon, 1986). The ownership mode of foreign affiliates, as expressed by different institutional arrangements such as joint ventures (JV) and wholly-owned subsidiaries (WOS), or equity stake of the parent in the affiliate, has occasionally been used as a moderating variable on the relationships of affiliate performance with its determinants, such as distance (Dikova, 2009; Dow & Larimo, 2011), environmental complexity (Luo, 2002) or host-country experience (Gaur & Lu, 2007).

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However, while theoretical concepts and empirical studies alike have pointed to the relevance of firm capabilities for succeeding in international operations (Fang, Wade, Delios, & Beamish, 2013; Luo, 2002; Xia, Qiu, & Zafar, 2007), much less attention has been paid to the role of the ownership mode on leveraging these capabilities (Chang, Chung, & Moon, 2013). Moreover, there is also contradictory evidence as to the propensity of firms to assume higher or lower ownership of foreign affiliates given particular constellations of firm capabilities and host country environments (Brouthers & Nakos, 2004; Brouthers, Brouthers, & Werner, 1996, 1999; Mani, Antia, & Rindfleisch, 2007). The performance implications of the governance mode of foreign transactions in different institutional contexts have remained rarely explored (Filatotchev, Strange, Piesse, & Lien, 2007; Gaur & Lu, 2007). Not least, we follow Brouthers (2013) in the assertion that while performance is affected by objective variables, such as the possessed capabilities or the environment for doing business (Meyer et al., 2009), ownership choices as strategic decisions are affected by managerial perceptions (Acedo & Jones, 2007). Hence, we argue that the level of parent control as achieved by assuming a given ownership over the foreign affiliate by the parent firm should be explored for its moderating effect on the firm- and country-level determinants of performance. This differs from a frequent perspective in earlier research in which the degree of internationalisation is affected by a number of objective factors (Cui & Jiang, 2010; Meyer et al., 2009). The present study builds on internationalisation theory which addresses the cross-border control over firm-specific assets, and incorporates the argumentation of institutional theory and organisational capability (OC) perspective in order to explore how ownership choices affect the ability to leverage their capabilities in foreign markets, as well as to cope with institutional distance.

We do so based on a study of foreign affiliates of Polish MNEs in different host countries. While empirical studies on emerging MNEs have predominantly focused on Asian economies, FDI from Central and East Europe (CEE) has received far less scholarly attention due to the novelty of the phenomenon and its still limited albeit dramatically rising scale. We focus on the context of Poland since it is a post-communist emerging economy (see e.g., MSCI, 2015) and a leading source of FDI from Central and Eastern Europe (CEE) (National Bank of Poland, 2015). Hoskisson, Eden, Lau, and Wright (2000, p. 249) define “an emerging economy” as a country “that satisfies two criteria: a rapid pace of economic development, and government policies favouring economic liberalisation and the adoption of a free-market system”. Hoskisson et al. (2013) propose that Poland can be classified as a mid-range emerging economy.<sup>1</sup> “Compared to many other Central and Eastern European (CEE) transition economies, Poland has been able to foster better institutional development post breakup of the Soviet bloc.” (p. 1299). However, while its institutional framework may be relatively advanced as compared to some traditional emerging countries, it is still underdeveloped in terms of factor markets and in terms of infrastructure. The mid-range positioning of the country accounts for the fact that FDI of firms from Poland is spread over a balanced portfolio of advanced and emerging markets, posing a promising empirical context for the exploration of expansion into different institutional contexts, which is relevant for the institutional aspects of the present analysis.

More importantly, however, the context of a mid-range emerging economy is of particular interest for studying ownership

decisions in foreign expansion due to the nature of the MNEs from these countries. Ramamurti (2010: 419) distinguishes stages of MNE development, the first one being the ‘infant’ MNE which “is a firm taking the first steps toward internationalization, with a heavy reliance on exports, modes overseas production in a few countries, and unknown brands”. The second, “adolescent” stage of MNE internationalisation involves manufacturing in several countries, though still concentrated in the home region, and up-and coming brands.<sup>2</sup> It is these types of immature MNEs that Hoskisson et al. (2013) collectively refer to as “new MNEs”. As these firms from emerging markets may be at different stages of their lifecycle related to international operations, they also differ in the ways in which they access and configure resources and capabilities required for internationalisation, as well as modes of foreign market entry.

While there has been a wealth of studies devoted to such phenomena as early internationalisation (e.g., Li, Qian, & Qian, 2012), born globals (e.g., Gabrielsson & Gabrielsson, 2011), or international new ventures (e.g., Schwens & Kabst, 2009), they have not focused on MNEs as the object of interest, focusing on aspects related to international entrepreneurship and the role of individuals and their cognition (Acedo & Jones, 2007), rather than emergent MNE strategy. Indeed, as Ramamurti (2010: 423) points out, while mainstream IB theoretical concepts have focused on separate aspects of firm internationalisation in isolation, the study of early-stage MNEs allows exploring “internally consistent why-where-and-how strategies for internationalization. Research on EMNEs provides the opportunity to make such horizontal connections between islands of IB theory”. Amongst these “how” questions, Hoskisson et al. (2013: 1314) highlight the fact that “the effectiveness of a firm’s FDI decisions may also depend on its governance characteristics, such as the distribution of ownership and control” and that it is in the context of new MNEs that the knowledge on such choices can be enhanced.

The study begins by framing the theoretical discussion around internationalisation theory and institutional theory in order to formulate baseline hypotheses on direct effects. Subsequently, the conceptual discussion draws on the organisational capability perspective and empirical studies on ownership decisions in foreign affiliates, leading to the formulation of hypotheses on the moderating effects of parent control. The next sections contain, respectively, the methodology and principal findings of our empirical study, as well as a discussion about their relevance and implications.

## 2. Theoretical background and research hypotheses

### 2.1. Internalisation theory, institutional theory and foreign affiliate performance

The concept of firm-specific assets (FSA) as the main drivers of firm success in foreign markets has long constituted a major tenet of some key concepts of international business (Caves, 1971; Hymer, 1976; Rugman & Verbeke, 1992). According to the monopolistic advantage theory, firms require the possession of value-generating assets in order to overcome their liability of foreignness (Hymer, 1976). Firm capabilities are also a central construct of the resource-based view which regards a firm as a bundle of capabilities and knowledge where individual skills, organisation and technology are inextricably woven together

<sup>1</sup> By mid-range emerging economies they understand emerging economies which may be relatively advanced either in terms of institutional development, or infrastructure and factor market development, but not both of them simultaneously, which would then be a feature of newly developed economies.

<sup>2</sup> It is not before the third stage of mature MNE that it operates in most major markets and regions, with advanced value adding activities transferred abroad and recognised international brands. It can be argued that it is this stage of MNE development that mainstream IB theory and research has focused on.

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