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Emerging economies and institutional quality: Assessing the differential effects of institutional distances on ownership strategy

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ABSTRACT

The current study contributes to the institution-based view of internationalization that is contingent upon the home country development. We examine the differential effects of formal and informal institutions on emerging market multinational corporations' (EMNCs) ownership strategies. Facing a large informal institutional distance that represents diverse cultural beliefs, EMNCs opt for a low ownership position that alleviates legitimacy threat, whereas a large formal institutional distance leads EMNCs to establish dominant ownership control. EMNC home market conditions, including market size and regulatory institutional quality, further explain the differential effects of institutional distances.

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1. Introduction

Multinational corporations (MNCs) determine an appropriate level of ownership (i.e. the extent of equity investment) in a foreign subsidiary by evaluating various critical strategic considerations, such as ownership control and resource commitments (Delios & Beamish, 1999; Taylor & Zou, 1998). Traditionally, transaction cost economics (TCE) researchers suggest that, the environmental uncertainty increases a foreign acquirer's difficulty of searching, negotiating, and monitoring market transaction partners (Williamson, 1981). Increasing ownership control will reduce the transaction costs and thus improves governance efficiency (Brouthers & Hennart, 2007; Yang, 2015). However, examination of TCE was not fully carried out in some cases where a firm perceived host-home national differences as a high level of environmental uncertainty and opted for lower equity participation to diversify the investment risks in the unfamiliar market (Zhao, Luo, & Suh, 2004).

Seeking an alternative framework to analyze national differences, international business researchers suggest institutional theory as a promising perspective to advance entry strategy research (Brouthers & Hennart, 2007; Martin, 2014). Institutional theorists suggest institutions provide rules of the game that organizations ought to follow to gain legitimacy which is critical for their success and survival (DiMaggio & Powell, 1983; Suchman, 1995). Facing a large institutional distance, which refers to the differences in home-host countries' institutional environments, a foreign acquirer potentially faces the threat of lacking legitimacy due to their unfamiliarity with the host market (Kostova, 1997; Xu & Shenkar, 2002). To overcome the legitimacy threat, a foreign acquirer presumably can benefit from the existing acquired firm's legitimacy in the host market by sharing ownership with the acquired firm (Estrin, Ionascu, & Meyer, 2007; Xu & Shenkar, 2002). Some studies on advanced-market multinational corporations (AMNCs) render support for this legitimacy argument (Xu, Pan, & Beamish, 2004; Xu & Shenkar, 2002).

Outward investment of emerging market multinational corporations (EMNCs) provides a great opportunity for researchers to resolve the seeming paradox between the governance efficiency (i.e., high equity participation) considered in TCE and the legitimacy argument (i.e., low equity participation) discussed in institutional theory. Considering the institutional distance between EMNCs' home and host markets, we posit that the aforementioned legitimacy argument is likely to be secondary to EMNCs' governance efficiency concern for two contingencies. First, a low ownership position may not meet an EMNC's special agenda for foreign expansion, such as seeking strategic assets (Luo & Tung, 2007) and escaping home market institutional constraints (Cuervo-Cazurra & Ramamurti, 2015). A dominant position to secure ownership control rather than a minority stake can be

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desirable for EMNCs' strategic concerns derived from their home market constraints (Brouthers & Hennart, 2007; Delios & Beamish, 1999). Second, some studies such as Ang, Benischke, & Doh (2015) highlight the multi-dimensional nature and differential effects of the institutional distance. Due to the explicit nature and unified enforcement of formal institutional rules, EMNCs may comprehend and comply with the formal institutions in the absence of a local partner's assistance (Eden & Miller, 2004; Kostova & Zaheer, 1999).

Taking into account the aforementioned contingencies that arise from the unique context of EMNCs, we design the current study to take a fresh look at one of the important inquiries in international strategy research: how do dimensions of institutional distance and home market conditions influence a foreign acquirer's ownership strategy? We argue that formal and informal institutional distances have opposite effects on EMNCs' ownership strategies in their cross-border mergers and acquisitions (M&As). Driven by efficiency considerations, EMNCs will opt for a higher equity participation to enjoy a dominant ownership control in a host market with a larger formal institutional distance. On the other hand, facing a larger informal institutional distance, the EMNCs, driven by legitimacy concerns, will take less ownership and rely on the existing legitimacy of foreign counterparts to alleviate the legitimacy threat in the host market.

Further, we include two critical home market factors that highlight EMNCs' unique strategic concerns. Recent international business researchers suggest that EMNCs' particularly urgent agenda of foreign expansion mainly arises from constraints in their home markets (Cuervo-Cazurra & Ramamurti, 2015; Luo & Tung, 2007) and the contextual combinations of the home-host environmental factors are imperative in understanding EMNCs' international strategy (Child & Marinova, 2014; Cui & Jiang, 2012). Hence, we include EMNCs' home market size and regulatory institutional quality to study the moderating effects of EMNCs' home market characteristics on the relationship between institutional distance and EMNCs' ownership strategy. The two moderators of EMNCs' home market characteristics identified in the current study provide important evidence that EMNCs' ownership considerations in foreign expansion are constrained by their home market conditions (Child & Marinova, 2014; Cui & Jiang, 2012).

2. Theoretical background and hypothesis development

2.1. EMNCs' urgent need for internationalization and home market conditions

Among an array of entry modes, EMNCs have conducted a record volume of cross-border mergers and acquisitions to expediently establish global landscape (Luo & Tung, 2007). Compared to greenfield investment, acquisitions afford the EMNCs opportunities to work with the local partnering firms in exploiting cost-advantages and realizing the synergy benefits (Buckley, Elia, & Kafouros, 2014). Recent research suggests that EMNCs differ from traditional AMNCs in that EMNCs demonstrate an accelerated internationalization process (Bonaglia, Goldstein, & Mathews, 2007; Mathews, 2006). Other than the economic motivation (i.e., asset exploitation and exploration) of EMNCs' internationalization, researchers suggest that the inferior market-supporting institutions in EMNCs' home market play a significant role in driving EMNCs' early internationalization. Cuervo-Cazurra and Ramamurti (2015) argued that, in addition to the traditionally conceptualized "pull" factors (such as the large markets and wealthier consumers of advanced countries), "push" factors such as weak institutions and economic underdevelopment in their home countries drive EMNCs to invest in advanced countries. In other words, "escape motivation" will encourage EMNCs originating from countries with lower regulatory institutional quality to invest more in countries with higher regulatory institutional quality (Cuervo-Cazurra & Ramamurti, 2015).

2.2. Institutional distance and EMNCs' ownership strategy

Institutional distance, the extent of similarity or dissimilarity between home and host countries' institutions (Kostova, 1997), presents barriers for an MNC to reap the benefit of internationalization (Dikova, Sahib, & Van Witteloostuijn, 2010). In terms of formal institutional environment, countries differ with regard to the political and judicial regulations (e.g., common law vs. civil law), economic rules (e.g., contracts), and third-party enforcement (Dikova et al., 2010); as far as the informal national institutional environment, there are differences with regard to conventions, codes of conduct, and norms of behavior (Dikova et al., 2010). In the current study, we follow a majority of cross-border M&As research and use formal institutional distance to capture national differences in regulatory environment, while informal institutional distance represents the national cultural differences (Dikova et al., 2010).

A foreign firm's compliance responses to institutional pressure are critical to gain legitimacy in a host market (Raaijmakers, Vermeulen, Meeus, & Zietsma, 2015; Suchman, 1995). When responding to formal and informal institutional pressures in a host market, a foreign firm may gain legitimacy through different means. In terms of formal institutional pressures, such as regulations and laws, the legitimacy requirements are explicitly codified and usually enforced by a government agency (Scott, 1995). A foreign firm needs to change the company practices to comply with the institutional rules to be able to operate legally in the host market (e.g., Chinese firms' compliance with the product safety regulations in the U.S.). On the other hand, the isomorphism pressures from the informal institutions are exerted through mimetic and normative mechanisms (Scott, 1995). Without the centralized coercive mechanism, individual firms have discretion to comply with legitimacy requirements shaped by informal institutional pressures (Goodrick & Salancik, 1996), which thus presents greater challenges for foreign firms (Kostova & Zaheer, 1999).

A large institutional distance increases the liability of foreignness, raising the additional cost of doing business in the host market (Baik, Kang, Kim, & Lee, 2013; Bell, Moore, & Filatotchev, 2012). The liability of foreignness results in legitimacy threat in multiple ways, including the foreign acquirer's lack of host-market knowledge and relationships with local constituents, as well as potential discrimination hazards (Eden & Miller, 2004). One of the effective strategies to mitigate these legitimacy threats is by sharing ownership with a local firm to benefit from the existing legitimacy of the local firm (Xu & Shenkar, 2002). A local partner that is embedded in the host institutional environment can provide needed host-market knowledge as well as the existing network with suppliers and consumers in the host market (Xu et al., 2004). Additionally, the continuous equity involvement from the local firm benefits the foreign firm in that it allows the foreign firm to enjoy the "spillover effects" of the local firm's legitimacy in the host market, and thus becomes less likely to be the target of discrimination (Kostova & Zaheer, 1999; Yiu & Makino, 2002).

The implicit nature of informal institutional rules presents great challenges for EMNCs to comprehend the legitimacy requirements and manage acquired subsidiaries. For instance, extensive cross-cultural leadership research suggests there is no universally effective managerial approach across all cultural contexts (Jiang, Colakoglu, Lepak, Blasi, & Kruse, 2015; Kirkman, Chen, Farh, Chen, & Lowe, 2009). A managerial approach that is congruent with cultural values shared by local employees is more likely to attain

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