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Bring institutions into FDI spillover research: Exploring the impact of ownership restructuring and institutional development in emerging economies

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ABSTRACT

Extant studies exploring the influences of foreign direct investment (FDI) spillovers on the productivity of local firms have provided conflicting evidence. In particular, they have largely overlooked the important role of institutional mechanisms in the host market in understanding the sources of the variation in FDI spillover effects on the productivity of local firms, especially in the context of emerging markets. Using a comprehensive panel data set of manufacturing firms in China during 1998–2007, our paper presents an integrative framework of how FDI spillovers affect the productivity of local firms in emerging markets. We identify an inverted U-shaped relationship between FDI spillovers and the productivity of local firms in China. This result suggests the coexistence of and the interplay between the opposing mechanisms of FDI spillover learning opportunity and adverse competition. Drawing on the institution-based view, this study also develops contingency frameworks and arguments to explore the question of if FDI spillover effects are contingent on, or independent of, a local institutional context especially in emerging markets. We find that institutional mechanisms, such as the institutionally determined ownership restructuring and the different levels of subnational institutional development within the host emerging market, significantly shape the variation of FDI spillover effects on the productivity of local firms. This research highlights the importance of incorporating institutional effects in understanding the FDI spillover effects in emerging markets.

1. Introduction

Foreign direct investment (FDI) into emerging economies has dramatically grown. For instance, the five major emerging economies of Brazil, Russia, India, China, and South Africa (BRICS) remained the strongest performers in attracting FDI by successfully mobilizing total FDI inflows of $252 billion, which accounted for 21% of global FDI inflows (UNCTAD, 2015). The increase in FDI inflows into emerging economies has increasingly led scholars and practitioners to ponder the questions of if, how, and when local firms in the host market can benefit from the FDI inflows. The *FDI spillover effect* (e.g., Buckley, Clegg, & Wang, 2007; Caves, 1974) underlies and guides our investigation of if and when local firms in emerging economies benefit from the presence of foreign multinational firms.[1]

Inspired by the seminal work of Caves (1974) on FDI spillovers, scholars in the international business and strategic management literature have shown a sustained interest in comprehending how much influence FDI spillovers have over local firms in the host market. However, despite the theoretical attractions, the empirical research in this field exploring the effect of FDI on local firms in the host markets has produced inconsistent or even conflicting results. According to this body of literature, whereas some studies have found positive spillover effects (Buckley, Clegg, & Wang, 2002; Caves, 1974; Globerman, 1979; Kokko, 1996; Liu, Siler, Wang, & Wei, 2000), others have demonstrated that the presence of foreign firms has no (Feinberg & Majumdar, 2001) or even has a negative (Aitken & Harrision, 1999; Djankov & Hoekman, 2000; Kathuria, 2000; Konings, 2001) spillover effect. In part, this research is largely limited by its focus on the conventional positive or negative linear premise with insignificant attention to the role of the dynamic dimension of spillover effects and the possible nonlinear

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[1] FDI spillovers can be broadly defined as the informal transfers of resources, such as knowledge, technology, and management expertise, from foreign multinational firms to local firms in the host market (Chang & Xu, 2008). The terms FDI spillovers, technology spillovers, and productivity spillovers are often used interchangeably in the literature. The present study adopts the same approach although an attempt is made to use the term *FDI spillovers* to denote the same thing, namely, spillovers of resources from foreign firms to local firms in the host country for the sake of consistency.

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relationship between FDI and the productivity of local firms in the host market.

Previous research is also limited because it has not differentiated the FDI spillover effects among different types of local firms and has conventionally treated local firms in the host market as undifferentiated recipients of FDI spillovers. The empirical context of the FDI spillover research usually ignores the heterogeneity of the local institutional environment context within the large host market to explain the variations in the effect of FDI spillovers on local firms' productivity. The neglect of the effects of a heterogeneous set of firms with different ownership structures and the heterogeneous institutional local conditions across subnational regions in the host market may not be that critical for the FDI spillover research in the host markets, which represent a relatively homogeneous set of ownership structures or subnational homogeneous institutional environments. These effects are likely to be important for explaining the variations in the FDI spillover effect on local firms' productivity in host countries with a heterogeneous set of ownership structures and local institutional conditions across the subnational regions of these countries. This explanation is particularly relevant in the case of inward FDI in the emerging market context, which undergoes rapid ownership restructuring and institutional changes and whose subnational regions are more institutionally heterogeneous than those of the more advanced economies (Ma, Tong, & Fitza, 2013; Park, Li, & Tse, 2006; Peng, 2003; Xiao, Jeong, Moon, Chung, & Chung, 2013). This condition represents a particular shortcoming given that institutions in emerging markets significantly differ from those in developed economies. These institutional mechanisms in emerging markets may significantly affect the possible spillover effects from foreign multinational firms to local firms. From the institution-based view, institutions are not only different between emerging and developed economies, but they are also poorly or less developed and are relatively more heterogeneous in emerging economies than in developed economies (Park et al., 2006; Peng, Wang, & Jiang, 2008; Wan, 2005). The role of institutions is highly salient in emerging economies because the rules fundamentally and comprehensively change, and the scope and pace of institutional transitions are unprecedented (Peng, 2003).

Overall, we argue that the important institutional mechanisms in the host market may shape the relationship between FDI spillovers and the productivity of local firms especially in the context of emerging markets. Studies have suggested that the institutional contexts of emerging markets may significantly shape firm behavior and performance (Peng et al., 2008). However, previous research on FDI spillover has under-theorized the possible role of different institutional mechanisms. Research has neglected the fact that such mechanisms may significantly affect the *willingness* and *ability* of local firms in the host market to source and utilize potential technology spillovers or to protect them from the adverse competition effects imposed by foreign firms. Contrary to conventional predictions, these mechanisms may also reduce the need and potential for local firms to learn and source technology spillovers from foreign entrants and to enhance the *possibility* of strong negative FDI spillover effects (or competition effects) imposed by foreign entrants to local players. Consequently, previous studies in this field that have assumed institutions to be a "background" have not sufficiently considered the important institutional mechanisms through which FDI spillover effects can occur, the often poor market-supporting institutions in many emerging markets (Peng et al., 2008; Peng, 2003), and how these institutions enhance or constrain the FDI spillover effects for local firms in the host market. In the field of international business and strategic management, we still do not know if FDI spillover effects are contingent on, or independent of, a local institutional context especially in emerging markets. The relationship between FDI spillover effects and the increased productivity of local firms seems impossible to explore without an understanding of how formal and informal institutions affect the willingness and ability of the local firms to source positive FDI spillover effects and the possibility of foreign firms to create strong negative competition effects for local players (Chang & Xu, 2008). Previous research omitting institutional frameworks when examining FDI spillover effects has seriously limited our understanding of this subject in the international business and strategic management literature.

The purpose of this study is to fill these research gaps and to extend and advance the current FDI spillover and institutional literature. We consider two specific research questions, namely, if and how inward FDI affects the productivity of local firms in an emerging market and if and how local institutions matter in explaining the variation in the FDI spillover effects on the productivity of local firms in the emerging market.

Our study seeks to contribute to the literature in three ways. First, our study is motivated by the desire to better understand the dynamics of foreign firms' spillovers in emerging markets. Previous studies have examined the effect of FDI spillovers on the variation of productivity of local firms by focusing on a linear specification. However, they have ignored the fact that FDI spillovers tend to be a double-edged sword because theory-based predictions about FDI spillovers are both positive and negative. We contribute to the literature by presenting an integrative framework of how FDI spillovers affect the productivity of local firms in emerging markets and by proposing the coexistence of and the interplay between the opposing technology spillover learning opportunities and competition effects. We argue that as the presence of foreign firms in an industry increases, local firms can improve their productivity by learning advanced technology and management expertise from foreign firms. However, we do not expect this positive trend to be linear. Instead, local firms' productivity is likely to begin to fall as the presence of foreign firms exceeds a critical point. Obvious learning opportunities may gradually dry up, and the subsequent negative competition imposed by foreign firms increasingly dominates the positive technology spillover effects.

Second, this study seeks to advance the current FDI spillover literature by explicitly exploring if and how the heterogeneity in local institutions affects local firms in the relationship between FDI spillovers and their productivity through various market-oriented institutional changes in an emerging economy. Specifically, we draw on the institution-based view arguments to examine the effects of local institutional mechanisms and propose that the *institutionally shaped firm characteristics and subnational institutional environments* within a host emerging market may have significant moderating effects on the relationship between FDI spillovers and local firms' productivity in the emerging market. The firm characteristic in emerging economies, such as China, that is most significantly affected by local market-oriented institutional changes is the ownership pattern because of the ongoing process of ownership restructuring in these economies (Park et al., 2006; Xiao et al., 2013). In this study, *ownership restructuring* refers to the reform policy implemented by the Chinese government to restructure and transform its non-market-oriented state sector to marketized and modernized organization forms through government-initiated corporation and privatization. The ownership-restructuring reform adds new types of firms in the economy, thereby creating four prevalent forms of ownership in China, namely, state-owned enterprises (SOEs), collectives, reformed firms, and private firms. The latter two are the newly created firm types. Each ownership type may facilitate and constrain the incentives, willingness, and ability of a local firm to source and utilize FDI spillovers and the possibility to experience adverse competition effects imposed by the presence of foreign entrants. We also have limited understanding of the large variations in the subnational market-oriented institutional environments within the host emerging markets and the different moderating effects that such various regional heterogeneous institutional environments have on the relationship between FDI spillovers and local firms' productivity. Significant differences and heterogeneity likely exist in the formal and informal institutional developments in the subnational regions of a large host emerging market, and they result from the variations in the