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Institutional quality and internationalization of emerging market firms: Focusing on Chinese SMEs[☆]

Ping Deng[a,*], Shuo Zhang[b,*]

[a] Monte Ahuja College of Business, Cleveland State University, Cleveland, OH 44115, USA
[b] School of International Trade and Economics, Central University of Finance and Economics, 59 South College Avenue, Beijing 100081, China

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ABSTRACT

With growing interest in institutional perspectives on emerging market firms (EMFs), scholars become increasingly interested in probing the role of home country institutions in their internationalization in either "escape" or "fostering" view. We contend that the two mechanisms should be interconnected and viewing them together will stake out promising territory for future research. Dividing the internationalization of Chinese small and medium-sized enterprises (SMEs) into two stages: internationalization decision-making and international development, we theoretically argued and empirically proved that institutional quality is negatively associated with the propensity of SMEs to go overseas but positively associated with their overseas sales growth. These effects were contingent on firm-level characteristics of manager's experience and possession of internationally-recognized certification. Based on stepwise analysis of SMEs at different phases of internationalization, we broaden the application of institutional theories in the context of emerging economies by bridging the dividing arguments of escape-fostering views on how the quality of domestic institutions exerts different impact on EMFs and especially Chinese SMEs in their international venturing at different stages.

1. Introduction

With emerging market firms (EMFs) quickly rising to the center of global marketplace, scholars become increasingly interested in probing the role of home country institutions in the internationalization of EMFs (Meyer & Peng, 2016). In this growing domain of research, there have emerged two contrasting arguments, which can be summarized as an "escape" view and a "fostering" view (Sun, Peng, Lee, & Tan, 2015; Yamakawa, Peng, & Deeds, 2008). The escape view suggests that internationalization of EMFs is partially a response to home country institutional constraints (Boisot & Meyer, 2008; Witt & Lewin, 2007), whereas the fostering logic contends for a facilitating role of advanced domestic institutions that promotes EMFs to internationalize (Luo, Xue, & Han, 2010; Sun et al., 2015). To be puzzling, these two productive lines of research are developing separately despite that the two mechanisms can be interconnected; viewing these two contributions together may stake out promising territory for future research.

Moreover, the institutional quality does not only involve its sufficiency or completeness to support economic transactions, but also its capability to benefit different types of firms (North, 1993), however, findings of those studies are mainly based on sizeable cases (Deng, 2013), especially those state-owned enterprises (SOEs), ignoring small and medium-sized enterprises (SMEs) (Huang, Xie, Li, & Reddy, 2017; Liang, Ren, & Sun, 2014). Given that the mechanisms through which domestic institutions exert influence on these two types of firms are different, it is imperative to set SMEs as research objectives differently from SOEs in their international venturing, which was under-studied in prior literature. On the one hand, in emerging economies, while SMEs tend to face significant domestic institutional challenges (Cardoza, Fornes, Farber, Duarte, et al., 2016; Stoian & Mohr, 2016), SOEs often have the ability to use more proactive maneuvers to solicit institutional attention and win preferential treatment from the government (Narooz & Child, 2017; Shi, Markoczy, & Stan, 2014). A hostile institutional environment for SMEs at the sub-national level was also found in emerging economies, pushing SMEs to venture overseas (Cuervo-Cazurra, 2016; Nguyen, Le, & Bryant, 2013). On the other hand, the very nature of state ownership and government control of SOEs indicates a different set of institutional factors that SOEs have to pounder on in their pursuit of international expansion than their SME counterparts (Deng, 2013).

To fill the above important knowledge gaps, we draw insights from institutional quality literature (Kaufmann, Kraay, & Mastruzzi, 2010;

☆ Authors are listed alphabetically; both contribute equally and are corresponding authors.

* Corresponding authors.
E-mail addresses: p.deng@csuohio.edu (P. Deng), zhangshuocufe@gmail.com (S. Zhang).

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North, 1990, 1993) as our theoretical basis. This stream of research highlights the role of home country institutions influencing the strategic decisions and behaviors of firms. From this basis, and also by considering that firms' internationalization is characteristic of sequential steps of strategic decisions (Meyer & Thaijongrak, 2013), we develop an institutional quality framework and explicate how home country institutional environment influences the internationalizations of EMFs, especially those SMEs, at different stages. We divide the internationalization of EMFs into two stages: (1) the decision-making phase of internationalization, when firms are considering whether to go abroad or not, and (2) the international development phase, when firms have internationalized and are trying to develop further. Using *2012 World Bank Enterprise Survey* and its breakdown of Chinese enterprise data, we empirically test the function of institutional quality and the moderating role of a firm's characteristics – manager's experience and the possession of an internationally-recognized certification – on Chinese SMEs in their international venturing.

By combining institutional quality logic jointly with the role of internationalization phases, we can begin to generate insights by extending the core arguments of prior studies regarding the relationship of institutions and firms' internationalization (Deng, 2013; Kaufmann et al., 2010; Meyer & Peng, 2016; North, 1993). Specifically, we found that home country institutional quality is associated negatively with the propensity of Chinese SMEs to get involved in overseas operations in the initial phase, but positively related to SMEs' overseas sales growth in the development phase. This finding implies that low institutional quality spurs firms to escape to international markets, but quality institutions enhance their subsequently overseas sales growth. We also found that SMEs with managers who had longer related experience were less likely to decide to venture abroad when facing low institutional quality at home. When SMEs moved to the development phase, obtaining an internationally-recognized certification is highly beneficial to their international growth because the certification acts as an alternative source of a firm's legitimacy, thus weakening the negative impact of home country institutional obstacles.

Our theoretical arguments and empirical findings contribute to the literature in three main aspects. First, this study adds novel insights into the institutional quality literature by explicitly showing that quality domestic institutions may have dual effects on EMFs in their different stages of internationalization, thereby bridging the escape-fostering divide. Second, we focus on the internationalization of SMEs, an important, yet understudied issue in this growing stream of research. Third, our empirical effort answers the call to explore the interaction between macro institutional effects with the micro firm-level effects, enabling a deeper understanding of the sources of strategic variation in firms' internationalization. Our study thus portrays a relatively more complete picture of the institution-internationalization connection of EMFs than previous studies have suggested and could significantly advance our knowledge of this interesting topic of growing importance.

2. Theoretical background

Since the initiation of market reform in 1978, China has experienced economic growth at a staggering rate. As the second largest economy in the world, China is producing not only business giants but also is witnessing dramatic rise of SMEs. By the end of 2013, of all the registered enterprises, 97.33% were SMEs, contributing more than 60% of China's GDP (NBSC, 2013). The prosperity of SMEs is attributable partly to government promotions, even though the initial economy reform was not designed to favor SMEs (Economist, 2012; Huang, 2008, 2011; Nee & Opper, 2012). With the remarkable economic achievement domestically, Chinese firms are competing in the international arena. In the last two decades, the outflow of Chinese foreign direct investment (FDI) has increased considerably (Morck, Yeung, & Zhao, 2008); by the end of 2016, China has surpassed Japan and become the second largest source of outward FDI in the world (UNCTAD, 2017). SMEs have been participating in this "China goes global" strategy significantly, accounting for 36.6% of the total export volume in 2013 (NBSC, 2013). As SMEs in China are integrating further into the global economy, they have huge potential to expand their role even more (Tang, Tang, & Katz, 2014; Zhang, Ma, Wang, Li, & Huo, 2016).

2.1. Institutional quality and internationalization of Chinese SMEs

With consensus that institutions matter (Marquis & Raynard, 2015; Peng, Wang, & Jiang, 2008), the institutional-based view has become a pivotal theoretical approach to international business and entrepreneurship research (Deng, 2013; Meyer & Peng, 2016). Institutions have been proved to influence a firm's decisions on choice of location (Edman, 2016; Lu, Liu, Wright, & Filatotchev, 2014), market entry mode (Child & Hsieh, 2014; Schwens, Eiche, & Kabst, 2011), and strategic practices (Liang et al., 2014). This growing stream of research focuses on the impact of institutional environment on the international expansion of large Chinese SOEs (Huang et al., 2017; Liang et al., 2014). However, the state ownership and subsequently government control of SOEs indicate that the internationalization of SOEs tends to reflect government agenda (Deng, 2013; Shi et al., 2014).

Despite being the backbone of Chinese economic growth, relatively little work has been done on how the domestic institutions influence Chinese private SMEs in their international venturing, and the findings are mixed. For instance, policies such as establishment of financial funds and credit guarantee system at Chinese central and local government level have facilitated SMEs to compete in the global market (Luo et al., 2010; Sun et al., 2015). However, there are some studies (Cardoza, Fornes, Li, Xu, & Xu, 2015; Morck et al., 2008) that showed that Chinese SMEs internationalize by using their internal capabilities and institutional settings are not influential factors for their venturing abroad. We contend that one important reason that contributed to these inconsistent findings may be that measurements of institutional environment facing SMEs are either aggregated or treated as "unidimensional" variables, each influencing particular aspects of international activities separately (Jackson & Deeg, 2008). In essence, an institution is more of a dynamic and interrelated system rather than the simple addition of individual dimensions (Greenwood, Raynard, Kodeih, Micelotta, & Lounsbury, 2011), especially when we consider different internationalization stages of SMEs.

Based on prominent institutional studies (e.g., North, 1990; Scott, 1995) and the World Governance Indicator (Kaufmann et al., 2010), we define institutional quality as limited government intervention, fair court system, robust financial markets, and lack of onerous regulations. Institutional quality determines whether firms are able to access valuable and rare resources and knowledge to develop their competitive advantage. It also plays a vital role for SMEs to internationalize due to their liability of smallness or country or origin effects and difficulty in accessing resources domestically (Ji & Dimitratos, 2013; Sharma, 2011). Akin to a firm's reaction to institutional complexity (Greenwood et al., 2011), firms may employ proactive strategies in response (Huang et al., 2017; Zhang et al., 2016). Going abroad is one of the reactions that firms take to reduce their exposure to domestic institutional constraints (Stoian & Mohr, 2016).

On top of that, the majority of firms tend to internationalize through gradual, incremental steps particularly in terms of sequential operational modes (Meyer & Thaijongrak, 2013). There are also some firms, for example, "born global" firms (Knight & Cavusgil, 2004) and international new ventures (Cavusgil & Knight, 2015); they are internationally-orientated in nature and reach a high degree of internationalization right after inception (Li & Deng, 2017). The international expansion for both types of firms, however, would generally need to decide the timing of venturing out and thus involve two phases: an initial decision-making phase, when firms are considering whether to go abroad or not, and the development phase, when firms have actually engaged in expanding overseas and are seeking to

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