Institutional Voids, Investment Purposes, and Foreign Subsidiaries of Multinational Enterprises

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BIG Question:

"How and when do institutional voids (the lack and/or absence of market-supporting institutions) have implications for the performance of foreign subsidiaries?"

Introduction

Institutional voids represent a core phenomenon of interest in the international business (IB) research focusing on emerging markets. While this research has advanced our understanding of the phenomenon and its implications for MNE investment, strategy, and management, a closer examination reveals two potential shortcomings. First, much of the research in the area has emphasized the economic implications of institutional voids: institutional voids engender transaction-cost market imperfections, which constrain market exchanges and therefore limit efficiency. This perspective has been central to our understanding of institutional voids as hazards. However, a careful reading of IB research drawing on industrial organization theory (e.g., Stephen Hymer's contributions) suggests potential for institutional voids to generate structural market imperfections, which present market power advantages for incumbent MNEs (Dunning and Rugman, 1985) and thus suggest a consideration of institutional voids as advantages. A more complete understanding of institutional voids and their implications, therefore, requires a better appreciation of the associated transaction-cost and structural market imperfections. Research in the area needs to engage both the economic challenges institutional voids generate and the strategic advantages (i.e., market power advantages) they present. This dissertation aimed to do just that and by doing so sought to advance our understanding of this important phenomenon.

Second, research in the area provides only a limited understanding of whether and how MNE investment motives/purposes interact with host country institutional contexts to affect subsidiary strategy and performance. Research on investment motives/purposes is important as it can provide a useful departure from existing emphasis on the "how" questions (e.g., entry mode research) and draw scholarly attention to the 'why' questions of FDI. Prior research on investment motives (purposes) and subsidiary mandate/charter has advanced our understanding of the inherent strategic as well as structural heterogeneity among MNE affiliates (subsidiaries). However, we have a limited understanding of how such heterogeneity relates with the ability to deal with the hazards of (or tap the opportunities from) host country institutional voids.

This dissertation, therefore, aimed to address the aforementioned gaps. In particular, it sought to answer the following research questions: (1) whether, how, and when host country institutional voids have implications for the performance of foreign subsidiaries and (2) whether, how, and when investment purposes/motives for which foreign subsidiaries are established relate to the extent to which the subsidiaries/their parents overcome the hazards of (or capitalize on the opportunities from) operating in locations of high institutional voids.

Overview of the Dissertation

The dissertation is organized as a collection of three integrated essays. Collectively, the essays contribute to a better understanding of the structural and transaction-cost market imperfections associated with institutional voids. Whereas transaction-cost market imperfections have been central to research in institutional voids, this dissertation brings a scholarly attention also to structural market imperfection, which are endogenous to firms. Likewise, it advances our understanding of the strategic and economic implications of institutional voids for foreign divestment. In addition, by integrating insights from the investment motives and subsidiary mandate/charter literatures, the dissertation contributes to a better understanding of purposes underlying foreign investment and their performance implications. Further, the dissertation contributes to the notion of foreign divestment especially from locations characterized by high institutional voids and market imperfections.

The first essay draws on insights from the new institutional economics and industrial organization theory to examine the economic and strategic implications of entry to the African market. By leveraging insights from the investment motives literature and the subsidiary mandate/charter literature, the essay also examines the roles of investment purpose diversity and market-seeking orientation. To test the arguments in this essay, I used a paired-sample design of Japanese foreign subsidiaries entering Africa and OECD countries. Results from extended cox regression models generate useful insights. The empirical evidence suggests that Japanese foreign subsidiaries that entered the African market have a greater likelihood of exiting than their counterparts in the OECD markets. This finding indicates that the economic (i.e., transaction cost) challenges of entry to the African market outweigh the associated strategic (i.e., market power) advantages.

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The empirical evidence also suggests that Japanese foreign subsidiaries that entered Africa with diverse investment purposes and/or greater market-seeking orientation are less likely to exit than are their counterparts. These findings, thus, present investment purpose diversity and market-seeking orientation as potential mechanisms to mitigate the economic challenges of institutional voids. Further, the findings as well as theoretical arguments associated with investment purpose diversity can contribute to extending the firm scope argument to a subsidiary level. The essay introduces the notion of subsidiary scope, here represented by the within-subsidiary diversity of purposes, and advances an understanding of its implications for foreign subsidiary exit (or survival). As well, by considering investment purpose diversity, the essay addresses a call by Adner (2007) to engage the notion of flexibility by reassignment of resources (shifting resources to a more favorable activity in a subsidiary). Also, it finds that the unique structural and strategic attributes of market-seeking subsidiaries can help offset the hazards of institutional voids.

The second essay examines the effects of host country market and institutional conditions on the survival likelihood of market-seeking subsidiaries. The viability of such subsidiaries is contingent on the presence/absence of sufficient market opportunities in the host country. This essay argues that the pattern of income distribution in the host country is an important variable in determining market attractiveness and seeks to explore how this variable relates to the survival (or exit) probability of market-seeking subsidiaries. Drawing on insights from research in environmental munificence, market imperfection, and the NIE, the essay sought to examine the complex ways in which host country income distribution is associated with survival of market-seeking foreign subsidiaries. As well, it explored institutional boundary conditions for the proposed relationship.

Analyses of subsidiary-, parent-, and country-level data on 6,699 Japanese market-seeking subsidiaries operating in 47 countries suggest that host country income distribution has a complex relationship with subsidiary survival. Specifically, the essay finds empirical evidence suggesting a presence of a U-shaped relationship between income distribution and subsidiary exit in that subsidiary exit is high in host countries with highly egalitarian or highly dispersed income distributions. This empirical evidence supports the notion that market-seeking subsidiaries face a lower likelihood of exit in host countries with intermediate levels of income distribution (as measured by the Gini index). Post-hoc analyses indicate the inflection point to be at a Gini index of approximately 38. The maximum and minimum Gini indices in the data are 57 and 22 respectively, and lower Gini score indicates more egalitarian income distribution.

Empirical findings also uncovered another layer of complexity in the relationship between income distribution patterns and exit of foreign market-seeking subsidiaries. The study finds that host country institutional development offsets the hazard posed by extreme levels of income distribution. By reducing transaction and information costs associated with exchanges, free-market institutions compensate for the product and factor market limitations that extreme income distributions engender and improve host country munificence. As well as advancing a more nuanced understanding of how host country income distribution relates with survival of market-seeking subsidiaries, this finding suggests the potential interaction between market and institutional factors and points to the need to examine such interactions to gain better understanding of subsidiary exit.

The third essay advances theoretical arguments about the strategic implications of institutional voids by considering the potential effects of alternative governance structures to organize the relationship between MNEs and host countries. In emerging markets, where institutional voids abound, governments play a more active role in business activities and political connections yield greater benefits to business performance. Whereas existing research indicates the presence of different governance structures (or bargaining models) underlying foreign direct investments in developing countries, synthesizing these approaches and examining their comparative performance implication has been largely limited. This essay aims to contribute to filling this lacuna by identifying three alternative bargaining models – namely, the one-tier bargaining, the modified one-tier bargaining, and the two-tier bargaining models – and theoretically examining their characteristics using arguments from Hillman and Hitt (1999) about the nature of political actions. In doing so, the essay not only advances a better understanding of these bargaining models and their implications, but also offers a potential explanation for the increasing competitive edge of Chinese MNEs in such developing countries as those in Africa (e.g., UNCTAD, 2015).

Following Hillman and Hitt (1999), the essay categorizes the three bargaining models along the two dimensions of the level and nature of political participation. The level of political participation takes either individual (i.e., MNE) or collective (i.e., state); the nature of political participation includes transactional or relational. Thus, using the dimensions, the essay identifies that the modified one-tier model – typically characterizing Chinese resource-seeking FDI in such developing countries as those in Africa – follows the collective-relational approach to political connection. To establish a theoretical link between a given bargaining model and competitive advantage benefits spilling over to associated subsidiaries, the essay first forwards theoretical mechanisms suggesting the marginal benefits of using collective as well as relational approaches to political connection. Then, it integrates mechanisms along the two dimensions to forward a proposition suggesting the value to competitive advantage of using the collective–relational approach (or the modified one-tier bargaining model). The proposition suggests the presence of influence rent and its potential implications for market competition. Resource-based view, resource dependence theory, and the NIE provide the requisite foundations for the theoretical development.

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The essay further refines its theoretical development by identifying relevant boundary conditions to the proposed relationship. It identifies investment motive and institutional development (economic and political) as potential boundary conditions influencing the baseline argument (i.e., the positive relationship between the use of the collective-relational approach and competitive advantage). The greater asset specificity characterizing resource-seeking investments can give rise to an increased threat of opportunistic behavior by host country government. Such investments, therefore, place MNEs at a less favorable bargaining position. In such instances, the collective-relational approach is likely to be the most preferred. The presence of a collective actor such as the home government and the inherent commitment to building long-term relationships underlying this approach can circumvent threats from reduced bargaining power. The essay also advances theoretical arguments suggesting that development of institutions can undermine the need for and value from strong political connections. As economic and/or political institutions develop, MNEs tend to enjoy increasingly better protection of property rights and enforcement of contracts. Under such conditions, the potential spillover advantages flowing to foreign subsidiaries drawing on the collective-relational approach is likely to be inconsequential. These arguments point to the potential tradeoff between market power advantage (through such strategizing efforts as political connection) and efficiency advantage (through reduced transaction costs).

Contributions to Theory and Practice

Collectively, this dissertation makes the following empirical and theoretical contributions. First, by engaging both the economic and strategic mechanisms underlying institutional influences, it advances a more nuanced understanding of how host country institutional conditions relate to foreign divestment. Second, it integrates insights from the eclectic paradigm of foreign production and the investment motives literature to respond to calls for research looking at the interaction between location factors and investment motives. Third, it contributes to the institutional voids literature by suggesting response mechanisms operating at the subsidiary level (i.e., investment purpose diversity and market-seeking orientation) and at the multi-party bargaining level (i.e., the collective–relational approach). Fourth, it contributes to our understanding of how the effects of host country (dis)advantages can be best understood by identifying a form of organization for which such factors are more relevant. Fifth, it extends the investment motives literature by indicating the useful insights to be generated by considering the fine-grained aspects of investment motives (i.e., investment purposes). Sixth, global strategy research has largely ignored Africa as a research setting and income inequality as a phenomenon, limiting our understanding of both. This dissertation responds to the numerous calls to help fill these gaps. Finally, it advances our understanding of foreign divestment by considering how market conditions, market-supporting institutions, and their interactions with investment motives relate with foreign divestment.

As well, the dissertation generates insights that practitioners and/or policymakers may find useful. Understanding that institutional voids have strategic implications, as well as economic implications, is useful for practitioners as it (1) broadens their understanding of host country institutions and (2) helps them in devising mechanisms to deal with or leverage such institutions. Further, practitioners can also learn about, and wherever possible use, the response mechanisms identified to mitigate the economic challenges of, or take advantage of the strategic benefits from, institutional voids. For policymakers, it provides a useful reference regarding the implications of unavailable institutions for the long-term viability of foreign MNE subsidiaries. It also provides a better understanding of how developments in both political and economic institutions can promote and/or discourage rent-seeking behavior of home countries, MNEs, and/or their subsidiaries.

By emphasizing the heterogeneity in foreign subsidiaries with respect to their motives and/or purposes, the dissertation also helps inform decision making both at the firm and host country levels. At the firm level, its findings suggest that the interface between host country institutions and subsidiary performance depends on the motives driving the subsidiary. For example, the dissertation indicates that resource-seeking subsidiaries are less likely to develop the capability to deal with host country institutional voids and therefore other mechanisms need to be used to create/promote such capability. The dissertation offers suggestions regarding some of these mechanisms. At the host country level, the dissertation can inform policy decisions by generating insights about the strategic and structural differences among different kinds of subsidiaries. It provides empirical evidence suggesting that policy prescriptions to attract and/or retain, for example, market-seeking subsidiaries are likely to be different from those used for resource-seeking subsidiaries.

Findings from this dissertation also suggest the need for organizations to consider socio-economic forces more closely and critically. Particularly, they show how the probability of subsidiary exit changes along different levels of income distribution. In like vein, this dissertation provides the management of MNEs with useful information about the exit risks associated with different investment locations that have different income distributions. Finally, for host country governments, these results provide empirical evidence about when and how income distribution relates to business exit, thereby informing pertinent policy decisions.

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