Beyond the Economic Institutions of Strategy:

Strategic Responses to Institutional Variation

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In ‘The Institutional Environment for Multinational Investment’, I argued that the “effect of political hazards on the choice of market entry mode varies across multinational firms based on the extent to which they face expropriation hazards from their potential joint-venture partners in the host country (the level of contractual hazards). I sought to combine an international business perspective on country risk with a transaction cost perspective on counterparty risk. The identification of the interaction between the hazards associated with the political environment in the host country and the hazards associated with the transaction itself on the choice between a wholly owned subsidiary and a joint-venture as a market entry mode was purportedly the value added of the analysis. Since then the paper has been widely cited in multiple disciplines yet in not a single instance in either domain were those interactions highlighted or modeled. Instead, the emphasis by other authors has been on the importance of the country-level institutional environment and, in particular, the political hazards emanating from that environment, for country-level economic or policy outcomes, the price or magnitude of investment, the entry mode of investment or the performance of investment. Only a handful of third-party citations even considered the impact of population-level institutional factors, firm-level experience or attributes or transaction-level characteristics on the various dependent variables listed above. As opposed to exhibiting frustration at the lack of broad acceptance of the core argument of the paper, my own recent work concurs with the external community by focusing its attention on the operationalization and incorporation of additional features of the institutional environment into the study of strategic management. In this essay, I review the development of the literature on the institutional environment for multinational investment emphasizing the unanswered questions and topics for future research at the intersection of institutions and international business.

Background

The 1980s and 1990s constituted a boom period for foreign direct investment. The opening of dozens of new nations to foreign direct investment and the associated confidence in these countries long-term growth potential led more multinational firms from more countries to undertake investment of greater magnitude in more countries than in any previous historical period. In his 1985 *Havrard Business Review* article 'The Globalization of Markets', Theodore Levitt (1983) famously advised companies to expand quickly to global scale or else. More recently, Thomas Friedman (2005) echoed Levitt's conclusion in The World Is Flat. Distance was dead. Markets were converging. Governments were helpless in the face of the power of global finance. The question posed to managers of multinational corporations was not where to invest globally but rather how fast. During this period, the United Nations reports that the magnitude of global foreign direct investment surged in real terms from $89 billion to $471 billion (constant 2000 USD) or from 0.5% to 4.4% of global output. The percentage of those flows destined for developing and transition economies soared from 13.9% to a peak of 41.4%.

In the late 1990s, however, in the aftermath of the Russian and Asian crises, we relearned the importance of national context. It turned out that privatization and liberalization were insufficient to sustain this unprecedented surge in multinational investment. Market-supporting institutions that protected investors against insider dealings by host country partners, financiers and government officials were suddenly in demand but short supply. In 1998, Merchant International Group (1999) reported that mishandling non-conventional risks cost multinational companies more than $24b in 1998. From 1995-98, 84 per cent of operations in emerging markets have not met their financial targets amounting to an average 8 per cent to 10 per cent erosion of companies' total expected returns. PriceWaterhouseCoopers reported that a one

standard deviation increase in the “opacity” of a political system was the equivalent of a 33-46 percent increase in taxation for equity owners or 9-13 percent increase in risk premium for bondholders (Wei & Hall, 2001). According to a World Bank study (Guasch, 2004), between 15 and 30 percent of the contracts governing $371 billion of private infrastructure investment in the 1990s were subject to government-initiated renegotiations or disputes. The lessons spread slowly from Russia, Thailand and Indonesia to emerging markets around the world. Good governance, transparency, financial market supervision, competition policy and credible commitments were suddenly in vogue. Risk regained its balance with opportunity in the discourse on globalization. United Nations data shows that foreign direct investment flows fell in real terms from $1.41 trillion in 2000 to $515 billion in 2003 (constant 2000 USD) or from 4.4% to 1.5% of global output. The percentage of those flows destined for developing and transition economies fell from a peak of 41.4% to as low as 18.8% before reaching a new peak of 43.6% in 2004.

In the midst of this reassertion of the importance of national context, an indicator that captured fundamental differences in the risk profile of potential host countries was likely to receive a sympathetic ear. The perceived esoteric application of this measure to highlight the interdependence between country and counterparty risk was less important than the existence of the measure itself. A measure that could *ex post* highlight why Indonesia was not, as recorded by subjective risk measures published by *The International Country Risk Guide* or *The Economist*, roughly equivalent to Chile or Poland in its risk profile but rather more akin to China or Kazakhstan was of great interest. More than theoretical precision, the impact of this work emphasizes the virtues of timing, measurement and the benefits of creating public data. The international business and strategic management literatures had high demand for a metric derived rigorously in alignment with theory capturing one relevant characteristic of the institutional

environment (the existence of checks and balances that limit the discretion of political actors to alter policy) across all countries in the world in the post-war period. Despite the largely unexpected nature of the impact of the article, it remains instructive to examine the subsequent and necessary remaining development of the analysis of institutions on international business.

Political Hazard Management Capabilities: Existence

In order for this metric of political hazards to gain traction and acceptance in the international business and strategic management literatures, it had to influence the core decisions of multinational corporations: where to invest, how much to invest there and how to organize those investments. Ideally, firms that better followed such guidance would enjoy higher performance including lower failure rates among their overseas subsidiaries. Furthermore, if this source of heterogeneity in the institutional environment was so important for strategy and performance, it should be the case that some firms can acquire and exploit the capability to identify and manage policy uncertainty.

In a series of six articles co-authored with Andrew Delios, I pursued this research agenda piecemeal. Using a panel dataset covering the population of Japanese multinational corporations, we highlighted that not all multinational managers will be equally susceptible to political hazards or equally successful in influencing the policymaking process. We argue that, over time, managers operating in politically hazardous environments develop better routines for influencing that process. Specifically, managers' ability to maintain incentive alignment not only with their counterparties but also with a broader class of political and economic actors that can support them in the policymaking process improves via experiential learning.

Beginning with the choice of which country to enter, Delios and I find that while a lack of familiarity with a market and political hazards both serve as a deterrent to entry (Bennet & Green, 1972, Gastanaga, Nugent, & Pashamova, 1998, Green & Cunningham, 1975, Loree & Guisinger, 1995, Root & Ahmed, 1978, Stobaugh, 1969, Vernon, 1977, Wei, 2000), managers who observe that their peers have entered a given country or who themselves have extensive prior international experience in other countries are less sensitive to their own lack of experience in the focal country when considering whether to enter that country (Henisz & Delios, 2001). Using the metaphor of stepping stones, Barkema and Drogendijk (2002) examine the incremental nature of internationalization from the home country to similar countries and then to countries that share institutional characteristics with the first wave of countries entered. Relatedly, Rhee and Cheng (2000) find that Korean manufacturing firms with greater international experience were less likely to expand into a new host country incrementally. Further, firms with higher levels of resource recoverability were less sensitive to their lack of experience in a host country market especially when entering countries with labor cost advantages relative to Korea. By contrast, these alternative sources of information about the attractiveness of a potential host country do not alter managers' sensitivity to the deterring effect of political hazards. In a follow-on article, we demonstrate an important qualification to this result. We find that multinational firms who have extensive international experience in other politically hazardous countries are less sensitive to the deterring effect of political hazards when evaluating a potential host country market (Delios & Henisz, 2002). Together, the results of these two articles suggest that (1) political hazards remain a strong deterrent for investment even in the face of other sources of information suggesting that a potential host-country market is attractive; and (2) multinational

firms can, through accumulated experience in politically hazardous markets, develop the ability to identify and mitigate the negative effects of political hazards.

In Delios & Henisz (2000), we demonstrate that the sensitivity of a multinational firm to either political or contractual hazards declines in its relevant international or host-country experience. In Delios & Henisz (2002), we demonstrate that the conventional wisdom about the appropriate order of entry by multinational enterprises into a host country holds only for entries into countries with low political hazards. A large body of qualitative and quantitative research holds that multinational firms' overseas expansions should begin with a sales office and only later expand to a joint venture and, eventually, a wholly owned manufacturing facility. We find that in politically hazardous environments, by contrast, entry sequences begin with a manufacturing plant. We argue that opening up a local sales office is an act of competition with local suppliers or incumbent producers and is thus more likely to incur the enmity of political or regulatory actors. By contrast, opening a manufacturing plant for export generates jobs and hard currency earnings, thus crafting an alignment of interests with the host-country government.

In a related article Jeffrey T. Macher and I examined the choice by semiconductor manufacturers of where to build an overseas fabrication facility. We find that technologically advanced and lagging firms respond quite differently to tradeoffs between the deterring effect of a nation's political hazards and the attraction of a nation's level of technological advancement. Technologically advanced manufacturers, while attracted to technologically advanced nations, are unwilling to accept higher political hazards in return. By contrast, their technologically lagging counterparts do make such a tradeoff and, if they go to technologically sophisticated nations, also tend to choose those nations that are politically hazardous (Henisz & Macher,

2004). We surmise that these lagging firms are forced to take on the risk that they can reap the benefits of technological spillovers before adverse political events devalue their investment.

Subsequent work has extended these insights by considering how given the high (policy) uncertainty associated with low political constraints, firms seek legitimacy by conforming their entry and entry mode decisions to past decisions by different peers groups ranging from prior actions by managers within the firm, managers at firms in the same industry or managers at firms in the same country (Chan & Makino, 2007, Chan, Makino, & Isobe, 2006, Makino, Isobe, & Chan, 2004, Yiu & Makino, 2002). Policy uncertainty like market uncertainty or technological uncertainty gives rise to imitative behavior among organizations. Imitation is an effective strategy because it helps decision-makers keep search costs within reasonable limits (Cyert & March, 1963), sort out alternatives and legitimize their actions (DiMaggio & Powell, 1983, Mizruchi & Galaskiewicz, 1993).

My last article with Andrew examined the question of performance. We exploited cross-national variation not just in political hazards but also in political regime change to ascertain whether experienced firms have higher survival rates in politically hazardous markets because they have better information on or stronger influence over host-country governments. We observe that the performance benefits of experience transform into liabilities in politically hazardous countries that experience a regime change. We argue that this result is consistent with the hypothesis that experience generates real or perceived influence as opposed to merely enhancing information. Real or perceived influence depreciates rapidly and can engender retribution by the political actors in a subsequent regime. By contrast, information gained through experience should still be of positive value in the aftermath of a regime change (Henisz & Delios, 2004).

These results are consonant with a growing body of research in international financial economics (Faccio, 2006, Faccio, Masulis, & McConnell, 2006, Fisman, 2001, Johnson & Mitton, 2003, Khwaja & Mian, 2005, Leuz & Oberholzer-Gee, 2006, Morck, 2007, Morck, Wolfenzon, & Yeung, 2005) and in the study of international alliances (Siegel, 2008) emphasizing the importance of political relationships. Using various identification strategies, these studies have shown the high percentage of total corporate valuation in emerging markets related to political ties, the impact these ties have on capital governance, transparency, the likelihood of government bailouts and the likelihood of forming an international joint venture. Extending this logic across national borders suggests that senior management's personal ties to a host country (Virany, Tushman, & Romanelli, 1992) could well be an important source of rents and determinant of strategy. Additional data gathering efforts such as that of Bruce Kogut's 'Small World of Corporate Networks' research group can hopefully shed additional light on the importance of these domestic and international ties as well as their evolution across time.

Despite this progress, there remains a substantial and glaring weakness to this line of inquiry. The nature of these political hazard management capabilities was nowhere specified nor was the mechanism of their development. The demonstration of the existence of an empirical regularity consistent with a theoretical argument while a substantive research contribution lacked the impact of a similarly constituted argument resting on microanalytic foundations linking firm organization or action to hazard mitigation and pursuant performance benefits. In short, despite nearly a decade of analyzing the impact of political hazards on multinational strategy, scholars have yet to examine the precise elements of multinational strategy or governance that grapple with and have the potential to overcome political hazards. My initial effort to focus on a core organizational solution to contractual hazards (i.e., vertical integration) proved limited due to the

second-order effect economic organization had on the political influence of the investor. Parallel work emphasizing financial remediation of political hazards (Desai, Foley, & Hines Jr., 2004, Desai, Foley, & Hines Jr., 2007) suffers from exactly the same weakness. While firms may alter their organizational or capital structures such responses are far from central in their strategies to generate and retain value in politically hazardous markets. In order to identify the tools and tactics used by multinational enterprises to grapple with political uncertainty, the international business literature would have to engage the source of political hazards more seriously.

Interest Groups and Political Stakeholders

While checks and balances in national political institutions impede policy change thereby limiting political hazards, they do not preclude change nor eliminate hazards. When a proposed change in policy enjoys broad-based support from multiple interest groups and political parties, even the most constraining structure of political institutions and most heterogeneous profile of preferences can still yield a radical policy innovation. Policy volatility is a function not only of the strength of the constraints in the current policymaking process but also of the relative strength of the key political and economic actors that seek to influence that process (Baumgartner & Jones, 1993, Baumgartner & Jones, 2002, Baumgartner & Leech, 1998, Henisz, 2004).

Once again, my initial work focused on demonstrating the existence of an impact of interest group pressures on investment outcomes. Zelner and I explore the relationship between country-level political constraints and the strength of the industrial consumers of electricity on investment by state-owned electricity generation companies (Henisz & Zelner, 2006). We demonstrate that industrial users are able to successfully lobby the government to reduce

overinvestment or the inefficient use of existing investments by state-owned enterprises, for which they pay disproportionately. We also show that the relative success of industrial users in securing their desired policy outcome is a function of the political constraints in the policymaking process. When political constraints are high, industrial users are less successful in reducing overinvestment.

Bennet and I build upon this insight in subsequent work examining the dynamics of interest group action that can lead to renegotiations in contracts with host-country governments (Henisz & Zelner, 2005, Henisz & Zelner, 2009, Henisz, Zelner, & Guillen, 2005, Zelner, Henisz, & Holburn, 2008). We build upon institutional theory to highlight characteristics of host-country formal and informal political and social structures that present specific hazards to multinational investors. We highlight the importance of informal structures such as belief systems, traditional formal national structures such as checks and balances among political actors as well as international ties between the host country and its peers than can constrain or enable national behavior.

The next step in this analysis requires the demonstration that firms with experience in home and third countries characterized by certain patterns of interest group competition enjoy performance advantages in host countries characterized by policy uncertainty. The progress in this line of inquiry has long been impeded by cross-nationally comparable variation in interest group characteristics. Some progress has been attached recently in the modeling of the conditional impact of political business cycles (Vaaler & Block, 2004, Vaaler, Schrage, & Block, 2005, Vaaler, Schrage, & Block, 2006, Vaaler, 2008) or the ideology of the government (Pinto & Pinto, 2008) but these macro-level political characteristics do not have obvious firm-level implications for capability development or strategy implementation. By contrast, recent work by

Zelner & Holburn (2008) have identified two dimensions of interest group conflict (class conflict as captured by income inequality and ethnolinguistic conflict) whose management arguably provides firms with generalizable political capabilities that can be deployed in other nations. Zelner & Holburn show not only that firms from countries with few checks and balances are more likely to invest in other countries with few checks and balances but also that firms from countries with high checks and balances and high income inequality or entholinguistic fractionalization are more likely to invest in countries with few checks and balances then are their counterparts from countries with high checks and balances and low interest group conflict. These results suggest the existence of a generalized conflict management capability originating in management of assets in a country with low checks and balances, high income inequality or high enthnolinguistic fractionalization that has value in other nations with high political hazards.

Subsequent work will likely highlight the potential to accumulate this conflict management capability across a series of investments in multiple markets; that firms with such conflict management capabilities are able to take larger stakes and are more likely to assume a majority ownership position in their foreign investments. Such firms should also be more likely to enjoy higher performance including fewer delays, higher returns and lower rates of failure. Given recent methodological improvements, these studies will also likely account for the multi-stage selection process, the multi-level error structure (i.e., country-, parent- and subsidiary-level) and the interrelatedness of the focal firms' current choices as well as the relationship between the choices of the focal firm and its peers. Despite this likely trajectory of substantive theoretical, empirical and methodological progress, we will still have only a vague notion of what a political hazard management capability is, how and when it is deployed and under what conditions its deployment is cost effective or a source of competitive advantage. For such

insight, we will have to delve shift the focus of analysis from the economic impact of political institutions and interest group preferences to the actual political response by multinational corporations. Furthermore, our analysis of the political response has to move from the organizational question of do we lobby directly or via a third-party agent to the actual implementation of that political response irrespective of the identity of the implementor. In sum, instead of searching for evidence of the strategic response to political hazards where the light is brightest, we need to turn our attention to the less well explored terrain where economic organizations directly or indirectly alter the preferences of interest groups than can generate benefits or costs to them in the political arena.

Political Hazard Management Capabilities: Implementation

As in politics more generally, a great deal of any implementation strategy will focus on sensing and reshaping perceptions. Given the cognitive limitations of the managerial, economic and political actors, however, there exists a large range of potential policy outcomes. The actual observed outcome is the result of the political battle among interest groups with a stake in the issue (investors, key classes of consumers, and those affected by any externalities) to gain the support of uninformed, unorganized, or unaffected interest groups (Baumgartner & Jones, 2005, Kingdon, 1984). Key success factors in such efforts are the ability of the management team to detect relevant societal and institutional differences (Behrman, Boddewyn, & Kapoor, 1975, Root, 1968, Vernon, 1971, Vernon, 1977, Boddewyn & Brewer, 1994, Henisz & Delios, 2002, Henisz, 2003, Lyles & Steensma, 1996, Zaheer, 1995), the leveraging of a network of relationships linking the focal actor to secondary and tertiary political and social actors (Knoke, 1993, Knoke, 1994, Knoke, 1996) and the ability to communicate and frame a message so as to

rally support among these other actors (Hilgartner & Bosk, 1988, Lamertz, Martens, & Heugens, 2003). I believe that we stand at the verge of enormous potential improvements in our understanding of multinational political activity precisely because of progress in each of these domains.

Scott & Orr (2008) build on the foundation of institutional theory to develop a framework highlighting the origins, resolution and dynamics of the resolution of what the authors call "institutional exceptions" (i.e., "an episode that involves an entrant first being surprised by, then making sense of, and then adapting to institutional differences arising between itself and local project players or external stakeholders." (p. 563). The authors emphasize the ignorance of managers regarding the socio-political context as the primary driver of deviant behavior which triggers cues of disapproval of varying intensity. Managers respond by engaging in a process of sensemaking that involves the search for relevant contextual information which can guide the design and implementation of a response. The largest problems were observed in cases with tight deadlines, irreversible costs and high task interdependence among actors with widely different experiences within and capabilities to make sense of the contextual environment. At one level, the micro-level focus on this work is refreshingly novel. On the other hand, however, the idea that transactions with high contractual hazards and inexperienced investors are prone to *ex post* conflict is already well established. The key step here is the outlining of the process of sensemaking which involves extensive internal and external consultation whose output is filtered through internal management to generate a specific adaptation to the existing policy. I next turn to the literature on social network to gain insight into the design and implementation of a process of local search with multiple stakeholders.

The methodology of social networks has rapidly expanded its scope of application and has now been used in a wide array of contexts including but by no means limited to research collaborators, corporate boards, investment banking, innovation, venture capitalists, small group social relationships, legal advisors, business groups, informal authority relationships within firms and political systems, employee mobility, social movements and terrorist cells. Scholars have made substantial progress in identifying the impact of characteristics of the overall network structure, the position of an actor within the network and network dynamics on the diffusion of an innovation from one actor to another, or on response of the network structure as a whole to a shock or innovation. Much as the study of organizational structure has unpacked the legal control rights of ownership and the importance of these rights under different assumptions regarding the contractual hazards in a given economic transaction, we now need to make progress in identifying the implications of the formal and informal political network in which an organization is embedded for its political influence under different assumptions regarding the political and economic hazards in a given transaction.

High priority research questions include

- What are the key dimensions of political and social transactions (i.e., issues of concern or policies) that can lead to a mobilization or activation of dormant or uninterested political and social actors? These determinants of political hazards should be akin to the Williamsonian derivation of contractual hazards using asset specificity (k), frequency (f), uncertainty (u) and probity (p). Candidates include but are by no means limited to externality and equity.

- What are the key dimensions of the political and social environment that magnify the impact of these political hazards? As described above, checks and balances in the political system and interest group preferences on a given policy are prime suspects to which one could add additional information on the distribution of preferences and the ties among political and social actors as well as their preferences towards each other.

    - What are the characteristics of a political or social actor's position in the country's informal political network that make them more pivotal or salient?

    - What are the characteristics of the country's informal political network that make it more susceptible or robust to shocks? More hostile to or tolerant of outsiders?

- What are the key characteristics of the organization's informal political and social network that influence its ability to sense and respond to threats?
    - How important is the alignment between the structure of the organization's network and that of the country? On what does it depend?
    - How important is the direct connection to pivotal actors in the country-level network? On what does it depend?

Having identified the informal political and social network of the country and the organization as the playing field on which an organization competes against its peers and other political and social actors for a desired policy outcome, the question remains as to the nature of that competition or the rules that it typically follows. Here key insights can be drawn from the literature on framing processes which highlight how given the bounded rationality of political actors (Baumgartner & Jones, 2005, Jones, 1999, Simon, 1985) strategic actors can "create and manipulate shared understandings and interpretations of the world, its problems and viable courses of action. Frames mediate between opportunity structures and action because they provide the means with which people can interpret the political opportunities before them and, thus, decide how best to pursue their objectives" (Van de Ven & Hargave, 2004) The authors concludes their discussion on collective action and institutional change by noting the potential for scholars of framing contests to make better use of the structure in which those contests take place specifically highlighting the potential for network theory in this regard (p. XXX). I believe that this insight applies not only to the intersection of the social movement and technology literatures but, as implicitly noted by the authors, more broadly to scholars of institutional change.

Here the high priority research questions are

- What actions by supporters of liberalization are most effective in leading to a framing of multinational investment in terms of opportunity as opposed to threat?
    - What policy innovations enacted by governments?
    - What strategic policies enacted by foreign firms and their domestic allies?
    - What role does local civil society play in this process?
    - What strategies by opponents are most effective in support of a threat frame and what can be done to defuse or counter these strategies?
- How are these actions dependent upon the political, social and economic context? Specifically, how do they vary according to
    - the structure of formal political organization and the nature of the competition among political organization?
    - the structure of economic organization and the nature of the competition among economic organizations?
    - the structure of informal political and social organization and the nature of the competition among political and social organizations?
    - the structure of the media and the nature of competition among media organizations.

Conclusion

Future research examining political influence strategies of multinational firms will retain an interest in economic organization and financial engineering as they relate to formal political structure but must move beyond the well trodden terrain in organizational economics, finance and political science. Clearly, policy outcomes are endogenous to the strategies of firms and those strategies include the transmission of a message through an informal political, social and economic network with the aim of influencing formal political authority. While data on such strategic moves is difficult to acquire, methodologies for summarizing and comparing framing contests and network structure are relatively nascent and ties between the political and social strategies and hazards and their economic counterparts remain poorly understood, ambitious

scholars will view this state of affairs as an opportunity for high impact academic research of enormous practical significance.

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