The effects of prior institutional experience as a leveraging mechanism in FDI competitive entry strategies

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Abstract:
The primary focus of neo-institutional economic theory has examined institutions as constraints on firms’ strategic choices. Implicitly, this view assumed that firms’ institutional experiences are static. More recently, scholars have recognized that a firms’ ability to manage institutional idiosyncrasies can be a possible means of capturing competitive advantage in failing institutional environments. Khanna (2002) presents the theoretical argument that firms who have local market know-how can seek “institutional voids” as a means to identify unique, sustainable quasi rents by leveraging their market power in areas which otherwise would be market failures. This paper builds on this theoretical groundwork and argues that a firms’ ability to leverage global institutional idiosyncrasies effects their FDI entry choice, modes of entry and sustainability of their entry position. I posit that firms are more likely to strategically enter host countries where they can leverage their institutional know-how from prior institutional experiences. I plan to empirically test my predictions through a proposed study examining the U.S. banking industry FDI in several host countries from 1980-2000.
Introduction

As the global economy expands and private participation increases in global markets, firms will continually be faced with the challenge of learning how to adapt to idiosyncrasies of institutional environments that are different from their home country institutional norms. The laws, regulatory environments, cultures and governmental structures have differing implications for a firms’ ability to make profits, organize and function productively (La Porta et al., 1998; North, 1991; Greif, 1995).

Neo-institutional theorists suggest that institutions act as market intermediaries that reduce friction and improve efficiencies of inter-firm economic activities (Foss, 1995; North, 1991; Greif, 1995). These scholars broadly define institutional environments as formalized market mechanisms such as regulatory bodies (i.e., SEC, FTC, EPA), stock exchanges, government agencies, or state and local legal systems to the informal institutional environments of cultural norms, codes of conduct, customs and social patterns that are taken for granted. For the purposes of this study, the discussion of “institutional environments” refers to and will be operationalized as three specific variables: 1) the type of governmental structure that a host country operates under (i.e., democracy, dictatorship, communist rein) and its level of stability, 2) the level of political stability, as a measure of the checks and balances within a governmental structure to mitigate corruption (Henisz, 2000a), and 3) the type of legal system (La Porta et al., 1998) and its stability.
Caves (1971:5) suggests that the institutional factors of “economic, social, legal, and cultural conditions” create barriers to foreignness. Scholars have explored the impact of such institutional effects on FDI and multinational expansion strategies (Henisz, 2000a & b; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998; Kogut & Singh, 1988; Khanna, 2002; Henisz & Zelner, 2001). These scholars have demonstrated that institutions can effect firm FDI entry choice, entry mode and success rates within an industry. These studies implicitly suggest that part of a firm’s choice to invest abroad is a function of the institutional landscape of a given host country. From these empirical results, we could infer that market environments with more institutional stability and efficiencies are able to benefit from higher levels of FDI while environments with weak institutional settings have lower FDI attracted to the market (Shaver, Mitchell & Yeung, 1997).

However, more recently, scholars (Khanna, 2002; Fisman & Khanna, 1998) suggested that in markets with weak institutional structures and a lack of stability may be attractive to some firms because of their ability to exploit such institutional voids. These voids may be appealing to some firms as a means to identify unique, sustainable quasi rents by leveraging their market power in areas which otherwise would be market failures (Khanna, 2002). For example, Air France has been able to leverage their ability to work within politically instable markets in Sub-Saharan Africa by being the sole provider of international flights. As a result of their know-how in dealing with the inefficiencies of the host country’s political instability, Air France is able to capture supernormal rents and act as a local monopoly. This theoretical perspective clearly suggests that institutional environments are not just intermediaries of market efficiency, but viable competitive landscapes for firms to identify their market positioning. Thus, firms are not
only effected by their industry institutional constraints, but they also have the ability to shape the institutional environment of the industry depending upon their influence and power with their industry (Fisman & Khanna, 1998; North, 1991, Morck & Yeung, 2002; Henisz, 2003). Henisz (2003) posits that in managing micro-level institutional idiosyncrasies of different host countries, firms can adapt by developing meta-level routines that allow them to identify institutional discontinuities and proactively influence the institutional powers structures that effect the firm. Therefore, the important mechanisms to examine in understanding firm FDI strategic choices is a function of both the host country institutional environment and the firms’ experiences and capabilities within a given institutional environment.

Several scholars have looked at the impact of a firms’ prior experience on FDI entry and entry mode decisions (own-firm and other firm experience, Shaver, Mitchell & Yeung, 1997; sequential entry mode, Chang & Rosenzweig, 2001; cumulative FDI experience, Erramilli, 1991; culture and entry mode, Kogut & Singh, 1988; other foreign experience, Mitchell, Shaver & Yeung, 1994; prior experience improves subsequent success rate, Li, 1995), but there is a dearth of research that examines the impact of a firms’ institutional experience on FDI entry decisions (Henisz & Macher, 2003). While theorists have illuminated that importance of political, legal, governmental and sociological institutional factors (Foss, 1995; North, 1991; Greif, 1995, Buckley & Casson, 1976; Henisz & Delios, 2002), none of subsequent research (Delios & Henisz, 2002) gives specific predictions to FDI on when firms will chose to enter, how they will enter, and how likely others are to follow their entry position decisions based on their prior institutional experiences.
My intention is to provide a better understanding of FDI entry, entry mode and sustainability of an entry position given a firms’ prior institutional experience. This paper will address the following research questions. When are firms likely to leverage their prior institutional experience by entering into new host countries? What entry strategies are firms more likely to use given their institutional experiences? And what competitive advantage, if any, do firms get from entering institutional voids? First, I will ground these questions in the current literature on FDI and the neo-institutional theory. Next, I will provide some theoretical predictions on which firms will enter, how they are likely to enter and the sustainability of their entry positions. Following, I will propose a methodology to test these predictions empirically and conclude by discussing the implications of such theoretical predictions.

**Theoretical Grounding**
In more recent institutional literature, much has been revealed about how institutional environments effect firms foreign direct investment decisions (Henisz, 2000 a & b, Henisz & Macher, 2003; Henisz & Zelner, 2001; Shaver, Mitchell & Yeung, 1997), but very few research studies have examined how firms contribute to institutional environments and potentially generate institutional norms. Morck & Yeung (2002) suggest that the two unanswered questions addressing how institutional environments effect FDI are: how do institutional environments effect firms’ economic behavior and how do agents behaviors effect the institutional environment? This paper will hopefully provide some enlightenment on both of these questions.

**Institutional Idiosyncrasies**
From FDI institutional theorists (Khanna & Rivkin, 2001; Henisz, 2000a & b, 2002, Khanna, 2002; Delios & Henisz, 2002), we know that the heterogeneity of institutional environments in various host countries alters firms economic behaviors and patterns of
investments in a given host country. To illustrate this point, Khanna & Rivkin (2001) examine the idiosyncratic patterns of institutional structures of several countries and demonstrate that there is no correlation between industry profits from one country to another. From this study, we can conclude that the determinants of success are different in each country. Henisz (2000a&b, 2002) and Henisz & Zelner (2001) demonstrate that risks of local political and partner arbitrage can be a hindrance to economic activity within a country. For example, Henisz (2000b) suggests that firms entering global markets with a high level of political hazard (as measured by corruption and direct taxation to multinationals) are better off entering the market as a minority joint venture with a local partner to avoid governmental expropriation, but are subject to private partner expropriation. La Porta et al (1998) demonstrate that global corporate ownership patterns are in part a function of the varying legal system and enforcement norms that impact the level of protection of shareholders rights. These studies suggest that there are economic trade-offs in varying entry mode strategies given the institutional environment of a country. Firms must be able to adapt to the unique institutional norms of each given host country to be successful with their investments.

**Institutional Experience**

From recent studies on FDI (Shaver, Mitchell & Yeung, 1997; Chang & Rosenzweig, 2001; Erramilli, 1991; Mitchell, Shaver & Yeung, 1994; Li, 1995), we know that firms with prior FDI experience are more effective in future FDI because they have acquired a knowledge base of prior experiences to leverage in potential future FDI experiences. Knowledge based theorists (Kogut & Zander, 1992; 1993) suggest that a firms ability to transfer their internal knowledge is what gives rise to their multinational growth. Several theorists have found that knowledge transfer is an effective means for carrying over learnings from one host country to another.
(Kogut & Zander, 1993; Martin & Salomon, 2003; Chang & Rosenzweig, 2001), however the literature primarily examines the effects of technology oriented knowledge transfer, not explicitly knowledge gained from experience with a given institutional environment. This cumulative knowledge that is tacit in nature is often referred to as a firms’ know-how (Kogut & Zander, 1992; Winter, 1987). I argue that as firms conduct FDI in various host countries, they gain institutional know-how of how to adapt to a given institutional environment. For example, a firm can have institutional know-how of how to work within countries that practice civil law versus common law legal systems (LaPorta et al, 1998), the ability of a firm to legitimately function in capitalistic and communistic governmental systems, or the ability to adapt to significantly different cultural norms (Kogut & Singh, 1988). I define institutional know-how as the accumulation of a firms’ experiences in FDI (as measured by the number of years experience with a specific type of institutional environment) in various home and host countries. Some firms are obviously more adept than others at utilizing their knowledge gained from one institutional environment to another. Thus firms that have more experience within a given institutional environment are more likely to excel in similar institutional environments.

**Institutional Voids**

Khanna (2002) suggests that firms can exploit this heterogeneity in institutional environments by strategically identifying market inefficiencies where the firm can leverage their power and influence. He posits that by fulfilling these institutional voids, a firm can identify possibilities for competitive advantages. Khanna (2002) defines institutional voids as the absence of specialized intermediation (economic entities such as legal rules, trade organizations, etc.) in buyer and sellers markets that generate market failures and increases the cost of doing business (i.e., lower transaction costs). He posits that these institutional differences are the
drivers of heterogeneity within a given market and effect the shaping of the industry structure, firm positioning, and sustainability of rents. This perspective suggests that 1) firms have the ability to influence the institutional structure of a given industry and 2) firms that have the ability to do this when others cannot may leverage such competitive advantages (as measured by supernormal rents). Thus, firms that are able to leverage their experience in weak institutional environments are able to take advantage of institutional voids. In this paper, I will operationalize institutional voids as the lack of political stability, legal rules, and lack of government stability (as measured by the number of years since inception or shift in governmental type). I argue that a firm’s potential to influence a given market is a function of their institutional know-how relative to the institutional environment of a given country. If a firm has relevant and meaningful institutional experience that does not exist or is weak in a given country, they are going to be well positioned to fulfill any institutional voids.

**Hypotheses:**

I predict that a firm’s ability to identify such institutional voids and specify their likelihood to leverage their institutional know-how in a given market will effect a firm’s FDI entry decision, entry choice, and the likelihood of sustaining an advantage over competition.

**Entry decision:**

First, we would expect that firms would enter into host countries that have the most similar institutional environments. FDI studies (Li, 1995; Shaver, Mitchell & Yeung, 1997; Mitchell, Shaver & Yeung, 1994) have demonstrated that firms are more likely to invest in markets where the firm or their peers have experience with the business practices and norms of
the local host country. Countries with characteristically similar institutional environments to
their home country provide an easier opportunity to acclimate to the differenced in doing
business abroad (Henisz & ). Therefore, we can expect the following hypothesis to be validated.

*Hypothesis 1a. (home country versus host country institutional environment)*

*Firms that have institutional know-how based on the norms of their home country are more likely to seek FDI entry choices in host countries that have similar institutional environments. Conversely, firms who have dissimilar institutional know-how based on the norms of their home countries are likely to not enter in host countries that have significantly different institutional environments.*

We would anticipate this finding especially in early periods of FDI for a firm where their primary reference point of institutional learning is derived from their home country experiences.

As firms gain more institutional know how from FDI in host countries, they acquire more experience giving them knowledge of how to manage investments in a variety of political structures, cultural norms, and governmental norms. This experience gives firms a greater ability to enter into markets that are also similar to other host countries of investment (Delios & Henisz, 2002).

*Hypothesis 1b. (subsidiary institutional know-how versus host country institutional environment)*

*Firms that have institutional know-how acquired from prior FDI in host countries of subsidiaries are more likely to enter institutional environments that are similar to their subsidiary host countries.*

One advantage that foreign firms typically have over domestic firms is access to their home country institutional norms which may be superior to the institutional norms of a given host country. Also, firms that have accumulated experience with FDI in a large variety of institutional environments are more likely to have figured out the nuances of different political environments and business practices. Therefore, firms with more accumulated institutional
know-how are going to have greater abilities to identifying opportunities and unique combinations of market solutions. Through studying FDI patterns in the service industry, Erramilli (1991) found that as a service firms’ experience increases with geographic diversity, firms tended to choose new markets that were culturally less similar to their home country. This suggests that firms become more geographically knowledgeable and risk seeking over time with their foreign investments.

Hypothesis 1c.
Firms that have institutional know-how acquired from prior FDI in home or host countries of subsidiaries are more likely to enter institutional environments that pose institutional voids.

Theorists (Khanna, 2002; Fisman & Khanna, 1998; Khanna & Palepu, 2000) suggests that firms can benefit from clustering together to generate substitutes for institutional voids in a given market. This clustering leverages the group’s power to establish and set the institutional norms in the market. These value creating substitutes can result with lower transaction costs or higher willingness to pay from the demand perspective (Khanna, 2002). This building of resources from interactions and interrelatedness strengthens the institutional fabric of an industry (Ingram & Inman, 1996). Agglomeration theorists (Jaffe, Trajtenberg & Henderson, 1993; Chung & Alcacer, 2002; Almeida, 1996) found that firms join agglomeration clusters as a strategy to benefit from agglomeration externalities (i.e., knowledge spillover, skilled labor). I posit that firms also enter the cluster to benefit from institutional externalities that have been established by prior firms in their respective industries. Firms that are lacking experience in a given institutional environment stand to benefit by entry into the industry cluster which provides the firm shared knowledge that fulfill their own institutional voids. Mitchell, Shaver & Yeung (1994) has shown that FDI success rates are higher when there is a moderate level of industry market share to leverage. In our prior hypothesis, we established that firms without experience
are going to be less likely to enter a market, however; the following hypothesis suggests that there is a condition where this propensity does not hold true.

**Hypothesis 1d.**  
*If entering firms have no institutional know-how that can be leveraged in a given host country, firms are likely to enter into an agglomeration clusters of their industry*

**Entry mode choice**  
Scholars (Henisz, 2000; Delios and Henisz, 2000; Chang & Rosenzweig, 2001) have demonstrated that prior experience and capabilities in a given environment effects the entry mode decision of potential investors. Henisz (2000) examines the FDI entry mode of firms that are limited by high levels of institutional instability (local market political hazards) and opportunistic exploitation of local joint ventures. His predictions suggest that firms entering global markets with a high level of political hazards (as measured by corruption and direct taxation to multinationals) are better off entering the market as a minority joint venture with a local partner. This strategy allows the firm to avoid governmental expropriation, but puts the multinational at risk for contractual expropriation from the local partner. These results suggest that institutional stability is a key determining factor for firm FDI entry mode choices. Likewise, Mitchell, Shaver & Yeung (1994) found that the success rate of firms with foreign investments is dependent upon the number of existing firms already in the industry. They found that firms have a higher chance of survival if they enter into an industry in a host country with a moderate level of industry peers, but not a high level of market saturation. Khanna & Palepu (2000) also suggest that developing professional groups can assist in minimizing market inefficiencies. This suggests that firms do better when they have peers or partners to leverage in the market. Therefore, we would expect that countries with institutional voids to be more reliant on partnerships to help buffer the institutional voids.
Hypothesis 2a.  
In host countries that have institutional voids (weak or inefficient institutions), but a moderate industry presence exist in the market, entering firms are more likely to enter by means of joint ventures with local partners.

Delios & Henisz (2000) examined Japanese firms’ FDI entry patterns and found that firms are more likely to have higher ownership interest in FDI depending on their level of organizational capabilities, their local partner’s potential capabilities, and any public or private expropriation hazards that may exist, such as political corruption. Therefore, in countries where there are institutional voids and very early development of the industry, firms will have to rely on their internal capabilities exclusively to drive the investment.

Hypothesis 2b.  
In host countries that have institutional voids (weak or inefficient institutions) and limited industry presence, entering firms are more likely to enter by means of wholly owned subsidiary.

Use Henisz (2000b) suggests that the greater the local political instability, the more firms should rely on local partners for joint ventures relationships as majority representation. This suggests that as a country’s level of governmental expropriation increases, firms may be better of partnering, which may in turn expose them to a potential lesser risk of partner expropriation.

Hypothesis 2c.  
The stronger the institutional void, the more likely firms will enter a host country through local joint venture.

Sustainability of Entry Position:  
While little research has been done in this area, firms also have the ability to set the institutional environmental norms by their presence in a new market situation. For example, Guiso, Sapienza & Zingales (2001) suggest that immigrants can change an environment’s
in institutional norms by initiating such behaviors that did not exist in the environment prior. They argue that by starting a trend of check writing as an acceptable business transaction, more trustworthy behaviors are institutionalized and become the new legitimate norm over time.

We would expect firms that enter first in an institutional void will benefit by gaining a competitive advantage over other market firms until other competitive entries. Firms who enter into markets with a unique set of institutional norms that provide efficiency in the face of a market failure (institutional void) are more likely to generate unique quasi rents versus entry that does not fulfill an institutional void. I posit that identifying these unique market positions is a more sustainable strategic position than more stable and proven institutional environments.

Hypothesis 3a.
Firms entering a host country with institutional voids have a higher propensity to sustain entry from competitors than firms entering in host countries with non institutional voids.

Proposed research design

Sample:
I plan to study the U.S. banking industry FDI patterns because on the vast amount of financial investments abroad historically and availability of FDI data in several countries. I will examine a longitudinal period from 1980-2000 which will allow me to see the patterns of investment over as a firm accumulates institutional know-how over time. I plan to use data published from the U.S. Department of Commerce on U.S. Direct Investment Abroad (Sagari, 1992) that provides a sample of branch offices, subsidiaries (wholly owned ventures) and affiliated banks (joint ventures).

Methodologies & Measures:
In my predictions there are a multitude of questions being addressed that examine whether firms are likely to enter into institutional voids, what mode of entry they will seek and the sustainability of their unique entry position. Because of the various analyses required, I will address each set of hypotheses with a different econometric model.

_Hypotheses 1a-c_

*Dependent variables:* For hypotheses 1a-c, the dependent variable is entry choice in a given host country.

**Entry** - FDI entry will be defined according to the FDI banking industry definition established by the Bureau of Economic Analysis (BEA), which delineates FDI as “business enterprises engage in deposit banking, foreign branches and agencies of U.S. banks…; and holding companies deriving over 50% of their income from banks they hold” (Sagari, 1992; 104). Entry is specified as a categorical variable for different host countries.

I have specified the following variables to measure the characteristics of the institutional environment and a firms’ institutional know-how.

**Country Characteristics:**

*Institutional environments* are operationalized as:

**Governmental type:** A categorical variable for type of government (e.g., 1 = Democracy; 2 = Dictatorship; 3 = Communist; 4 = Empires)

**Governmental stability:** Number of year with government type

**Legal type:** A categorical variable for type of legal system (e.g., 1 = Civil law; 2 = Common law; 3 = Social; 4 = Indigenous/Folk Legal Systems/Native American Law; 5 = Islamic Law)
**Legal stability:** Number of year with this type of legal system

**Political stability:** Henisz (20002) has specified a political constraint variable which measures the level of political stability in a country. This measure captures the level of veto power and checks and balances in a given governmental system that is expected to capture any potential levels of corruption and expropriations. This is a continuous variable that measures the level of stability in each country.

**Independent Variables:**

**Firm Characteristics:**

**Institutional know-how** is operationalized as a firm’s level of experience with the variables specified above:

**Firm know-how - Government type:** 0/1 dummy variables will be created to capture a firm’s experience with categorical variable for type of government (e.g., 1 = Democracy; 2 = Dictatorship; 3 = Communist; 4 = Empires) for each country. They will be coded for home country or host country experience to delineate results from hypotheses 1a and b.

**Firm know-how - Government experience:** Number of year experience with government type

**Firm know-how - Legal type:** 0/1 dummy variables will be created to capture a firm’s experience with categorical variable for type of legal system (e.g., 1 = Civil law; 2 = Common law; 3 = Social; 4 = Indigenous/Folk Legal Systems/Native American Law; 5 = Islamic Law)

**Firm know-how - Legal stability:** Number of year experience type of legal system
**Firm know-how- Political instability:** Lowest level of political instability with experience

**Controls:**

While Buckley and Casson (1976) suggest that FDI is a function of 1) industry-specific factor(2) region-specific factor (3) nation-specific factor and, finally, (4) firm-specific factors. Therefore, I will include control variable to control for the non-institutional mechanisms and other firm specific characteristics including culture, firm size, country GDP to mention a few.

**Method for Hypos 1a-c.**

I plan to use a multinomial conditional logit model to test hypotheses 1a-c to determine the likelihood of firm entry in a given country given their firm characteristics.

**Method for hypothesis 1d**

To test hypothesis 1d, I will examine the location choice of only those firms with no institutional experience in a given market, but sought FDI entry anyway (counter to the predictions of hypotheses 1a & b). I will examine industry concentration levels of the banking SIC code (or similar proxy) in each country. While this research plan is preliminary, I suspect this hypothesis would be more easily tested by selecting one primary host country to examine and illustrate the FDI pattern (i.e., perhaps a financially developing country such as Brazil).

**Methods for hypotheses 2a-c**
I plan to use a bivariate logit model to test which entry mode will be selected by firms entering in a given host country. The entry mode dependent variable will be a 0/1 categorical variable where 1 = joint venture and 0 = wholly owned subsidiary. The independent variables will be specified as the industry presence (as measured by the market share of the industry) and a firm’s institutional know-how (similar to measures for firm know-how above). Control variables mentioned above will be used in this model specification as well. Hypothesis 2c is a magnitude question so I will examine the magnitude of hypothesis 2a.

**Methods for hypotheses 3a**

To examine this 3a, I will examine the different timings of entry in countries with institutional voids versus no institutional voids. I will create a new variable called *entry sustained* which will measure the duration of an entry [position until the next competitor enters the market. I will create this measure by subtracting the timed lapsed between one firm’s entry to the next. I will specify the *institutional void* variable as the level of political stability in the country (see above) and/or the government stability variable. (see above). I will specify a multivariate regression model to predict the entry sustainability as a function of institutional voids, controlling for other market characteristics.

**Implications**

This paper illuminates the significance of firms being able to leverage idiosyncratic institutional environments. Several prior studies did not take into account the firm level experiences as a predictor of entry decisions and entry modes. This paper will provide some insight into the effects of a firm’s own experience in institutional environments.
**Limitations:**

This study is proposed to examine the banking industry, however; it is not clear that these same finding will hold true in the manufacturing and technical product industries. Banking findings are likely to not be generalizable to many other industries. So examining other business sectors would be useful. Also, Abernathy (1974) suggests that there are different cycles in product and technology innovation. Perhaps these cycles effect FDI patterns and a firm’s pursuit of institutional voids. Future studies should address these limitations.
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