Received 25 November 2015
Accepted 25 November 2015

DISTINGUISHED SCHOLAR ESSAY

International strategy and institutional environments

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Abstract

Purpose – Country institutions have become of heightened importance for firms' international strategies in recent years. The purpose of this paper is to review the reasons for the growing importance of institutional environments and examine how they influence the international strategies of multinational enterprises (MNEs). There have been significant changes in the global, economic and competitive landscapes in recent years. These changes are examined.

Design/methodology/approach – Three critical and interrelated changes in the global competitive landscape are identified. They include: more interconnected (interdependent) national economies; a significantly larger number of multinational firms; and growing importance of emerging economies (and their MNEs). These changes have increased the importance of countries institutional environments. Country institutions, both formal institutions (codified and explicit rules and standards that shape behavior) and informal institutions (shared norms that guide cohesive behaviors) are examined. The author explains the influences of institutional complexity, institutional distance and geographic regions on firms' international strategies.

Findings – Research has shown that both culture (informal institution) and formal institutions are interrelated and affect firms' strategies. And, while specific institutions such as intellectual property protection (law and enforcement) are important, the collective influence of institutions has a critical influence on firms' international strategies. And, institutions are multilevel (national, regional and local-municipal). The institutional complexity (combined effects of multiple institutions and their diversity) is carefully considered in executives' strategic decisions. When firms consider entering a new foreign market, they also consider the institutional distance between the home and host countries. The differences in culture and in formal institutions compose the institutional distance and affect whether and how firms enter these markets. Greater institutional distance contributes to the liabilities of foreignness the challenges of which must be managed effectively to succeed in the new market. And the effects of institutional distance are asymmetric depending on whether the firm's home country institutions are stronger/more developed or weaker/less developed than the host country institutions. Finally, many firms follow regional international strategies in which they invest in selected regions of the world. Recent research suggests firms enter regions that have attractive institutional profiles and engage in institutional arbitrage across the countries in those regions.

Research limitations/implications – This essay provides the base for additional research by identifying a number of important research questions on institutions and international strategy.

Originality/value – This essay highlights the importance of institutions for firms' strategies. Understanding institutions and their influence contributes to more effective executives' strategic decisions and more effective national and international policies.

Keywords International strategy, Institutional complexity, Informal institutions, Formal institutions, Semiglobalization

Paper type Viewpoint

Introduction

International strategies have been quite important in the growth and development of firms and have made major contributions to the health of many national economies. Several decades ago, multinational firms were primarily large, resourceful firms that used international markets to enhance their economies of scale for successful

Cross Cultural & Strategic Management
Vol. 23 No. 2, 2016
pp. 206-215

2059-5794
DOI 10.1108/CCSM-11-2015-0168

market-leading products in their domestic markets. Over the last 20 years, profound changes have occurred that reshaped international markets and economies and have thereby changed international strategies and how they are implemented (e.g. the type and use of human capital – see Tung, 2016). These changes have been facilitated by innovations in communications technology, advances in transportation and the opening of markets to foreign competitors.

Three critical changes are in evidence: more interconnected (interdependent) national economies; a significantly larger number of multinational firms; and growing importance of emerging economies in the global competitive landscape. All three of these changes are interrelated. For example, while the development of interdependent national economies and financial markets is partially related to the opening of markets to foreign firms, it is also derived partly from the increasing number of multinational firms (Hitt *et al.*, 2006). In fact, Sapienza *et al.* (2006) suggested that the heightened internationalization of large, small, established and entrepreneurial firms is one of the profound changes experienced in recent times. New and small firms have been better able to participate in foreign markets especially because of the advances in technology and transportation opportunities. In fact, many new ventures are now founded to operate in both domestic and foreign markets. These are referred to as "born globals" (Knight and Cavusgil, 2004). The increased number and diversity of participants in the international markets has changed the global competitive landscape (more intense competition along with greater economic growth – i.e. more challenges and opportunities).

In addition, the political landscape has been changing within countries and globally and multinational enterprises (MNEs) have a heightened need for resources, natural and human resources primarily. The changes in the political landscape are evidenced in many regions of the world to include Europe (e.g. European Union), Asia (e.g. China and India), Latin America (e.g. Brazil) the Middle East and Africa (instability). The search for resources has forced companies and countries to explore outside their boundaries/borders for needed assets and capabilities. This is evidenced in the business world by the growing amount of strategic alliances, cross-border acquisitions and outsourcing. Countries often seek natural resources as evidenced by China's investments in Brazil and Africa.

The changes in the economic, competitive and political landscapes and the external search for needed resources are interrelated and partially interdependent. Additionally, all of them have greatly enhanced the importance of countries' institutional environments for the MNE strategies and their implementation.

Institutional environments and internationalization

Country institutional environments are composed of both formal and informal institutions. According to North (1990) and Scott (1995), formal institutions are composed of codified and explicit rules and standards that shape behavior in a society. Alternatively, informal institutions involve long-lasting systems of shared values and understandings subscribed to by societal participants that are uncodified but guide coordinated and cohesive behaviors among them (Scott, 1995). Culture is based on shared values and non-codified standards and thus is representative of informal institutions (Fu *et al.*, 2004). So, both formal and informal institutions shape and guide behavior of individuals and organizations. But, one might ask, which is more important, formal or informal institutions? Does one group of institutions take precedence over the other one? Do their effects differ?

We can conclude that both types of institutions are quite important and have been shown to influence firm strategies and activities, perhaps in different ways, however. For example, Holmes *et al.* (2013) argued that informal institutions, particularly culture, were often more enduring than formal institutions. Major changes, and even incremental changes, in informal institutions such as culture frequently require centuries to inculcate. Formal institutions rarely change quickly but we observe that some formal institutions can change over time, especially when transformations in political regimes occur. Therefore, Holmes *et al.* (2013) argued that informal institutions, particularly culture, play an important role in shaping formal institutions. And, their empirical research provided support for this proposition. Essentially, informal institutions provide the base for and stability in formal institutions in a country (Hofstede, 2001). Thus, formal institutions to a degree reflect and reinforce a country's informal institutions (Inglehart and Baker, 2000). Holmes *et al.* (2013) found that several dimensions of culture were related to different formal country institutions. In turn, they also found that formal institutions affected firms' willingness to enter foreign markets. This research is important because it suggests that informal institutions provide a baseline for the development of formal institutions and formal institutions have direct effects on firm strategies. However, while this research moves us forward, there is still much more to learn about institutional environments and how they influence firm strategies.

Institutional complexity

Institutional environments are highly complex, partly because there are multiple formal and informal institutions. However, institutions are also multilevel. International business scholars (and others) frequently focus on country-level institutions. These institutions are very important and vary across countries. Yet, institutions also vary within countries across geographic regions and levels of government. Most formal institutions are products of governmental action. While the national government develops and implements formal institutions (e.g. legal, regulatory, economic), provincial or state-level governments and even municipal governments also develop and implement institutions (e.g. regulatory, economic) (Ostrom, 2005). Ostrom (2005) refers to the existence of multiple different institutions and multiple levels of institutions as polycentricity. She suggested that institutions emanate from multiple centers of power. So, institutions are characterized by multiplicity (Batjargel *et al.*, 2013) and exist at multilevels.

Let us consider a major Chinese firm that decides to enter the US market. By entering the US market, it must understand, contend with and conform to national formal and informal institutions. Thus, the US national government has laws and regulations pertaining to foreign firms selling their goods in US domestic markets. The Chinese firm must also contend with domestic economic policies that influence firms' operations in the USA. This Chinese firm must understand well the US culture because of its influence on customer actions, supplier relationships, employee behaviors and other stakeholders' expectations. Obviously, understanding and dealing with the multiple institutions at the national level can be challenging for this Chinese firm. However, there are more institutions with which it must deal. Let us assume that this Chinese firm decided to locate its manufacturing facilities in the state of Georgia and in a suburb of Atlanta. In this case, the firm also must understand and adhere to and operate within the laws, regulations and economic policies established by the state government of Georgia. In addition, the city of Atlanta will have economic policies (e.g. taxes) and regulations (e.g. zoning restrictions) with which the Chinese firm must deal. Finally, the subculture in Georgia, while clearly attuned to the national culture, has some idiosyncratic dimensions specific to that geographic area. This example suggests that there is a complex array of institutions that influence a firm's international strategy and which continue to influence foreign business operations after entering new geographic markets.

This discussion suggests that institutional environments can and do influence firms' international strategies. Specifically, they influence the choices of what foreign markets to enter and how to enter those markets. They also influence the firm's selection of the competitive strategy to use in those new markets, how to manage stakeholders in those markets, and the outcomes (e.g. performance) of the subsidiaries that operate in those markets. The research on institutions and strategy supports these conclusions (for a review, see Hitt *et al.*, 2016).

Much research on country institutions has shown the linkage between specific institutions and strategies. For example, firms may be more likely to establish major research programs in countries that have strong intellectual property protection (laws and their enforcement). Additionally, there have been several studies examining the strategic actions needed to perform well in countries with weak institutions such as building political connections to overcome significant corruption (e.g. Brockman *et al.*, 2013) or developing private certifications because of a lack of trust in government (Montiel *et al.*, 2012). Alternatively, Dhanaraj and Beamish (2009) found that an institutional environment evidenced by political and social openness enhanced the survival of foreign subsidiaries.

Although the studies on the influences of specific institutions have clear value, they do not provide a complete and fully accurate picture of the institutional environment's effects on firm strategies. Using the example of the Chinese firm entering the US market discussed earlier, one has to believe that only one or two institutions were a primary determinant the firm's decisions. And, did the Chinese executives consider different types and levels of institutions in a sequential manner? For example, were there specific national formal institutions that were most critical in their decision to enter the US market (e.g. regulatory, economic)? And, did they simultaneously consider the culture in the USA (informal institution) with (or before) the important formal institution(s)? After deciding to enter the US market, they had to decide where to locate the operations in the USA (or was it considered simultaneously with the decision to enter?). Did they simultaneously consider the state and local (municipal) institutions in the decision of where to locate the subsidiary? Did they consider subcultures and other informal institutions in the geographic alternatives along with the formal institutions in the localities? Some earlier research suggests that firms may consider regional informal institutions in their location decisions (e.g. Cole and Deskins, 1988) but we have little evidence how the multilevel institutions might jointly, simultaneously or sequentially affect market entry location decisions. Thus, there are a number of important questions that require further attention and research. And, perhaps our studies need to examine more complex combinations of institutions and consider sequential decisions in such market entry and location decisions.

Peng (2003) criticized the research on country institutions because it often focussed on one (or very few) institutions and assumed those institutions did not change. Responding to this criticism, Batjargal *et al.* (2013) used the work of Elinor Ostrom to examine how a confluence of country-level formal institutions influenced domestic new venture growth. Their research was based on the notion of institutional multiplicity (mentioned earlier) and institutional substitution (informal norms developed to compensate for specific weak formal institutions). Additionally, Greenwood *et al.* (2011) emphasized the importance of considering a pluralistic institutional environment because of the inconsistencies in institutions across environments and across time.

One topic on which there has been an increasing amount of research in recent years is that of institutional distance.

Institutional distance

The catalyst for the focus on institutional distance was the work by Kogut and Singh (1988) on informal institutions, i.e., cultural distance, and by Kostova (1999) on formal and informal institutional distance. Much of the research on cultural distance has shown that firms often begin their international expansion by entering foreign markets in close geographic proximity especially because those countries generally have more similar cultures (lower cultural distance). As firms learn from these experiences and develop capabilities to operate effectively in foreign markets, they begin to incrementally enter markets that are more culturally distant. The outcomes of this research largely support what has come to be known as the Uppsala model (Johanson and Vahlne, 1977). Alternatively, Dunning (1988) proposed his ownership-location-internationalization (OLI) framework suggesting that firms might invest in foreign markets in which there was higher cultural distance in order to overcome or take advantage of transactional and/or market failures. Other recent research offers different findings and suggests even more unique firm actions. For example, Knight and Cavusgil (2004) found that born global firms engaged in distinctive and diverse internationalization strategies that followed neither the Uppsala model nor the OLI approach. Very possibly the changes in the global economy and in the global competitive landscape explained earlier have produced different strategies. In many ways, the research suggests that there has been an evolution of MNE capabilities that allow them to pursue different strategies than in the past. In fact, new and more sophisticated international strategies may be necessary in order to survive in the new environment.

Although cultural distance is quite important because of firms' need to understand the cultural influences on behavior (customers, suppliers, employees and stakeholders), formal institutional distance may be even more important for successful international strategies. For example, many companies from countries with developed institutions have found it difficult to succeed in countries with weaker institutions especially when there are voids in critically important institutions (e.g. intellectual property rights, rules on transparency of accounting processes). In these countries, informal institutions (e.g. building relationships to ensure trust) often are used to substitute for weak formal institutions (rules defining corporate behavior). The research on formal institutional distance suggests that the transfer of capabilities and routines is more difficult when the institutional distance is high (Kostova and Zaheer, 1999). Thus, the effects of formal institutional distance on firms' international strategies (especially foreign market entry) largely mirror those on cultural distance (Cuervo-Cazurra and Genc, 2011). But, perhaps even more than cultural distance, formal institutional distance has a major effect on the modes that firms use to enter those markets. Higher distances often use non-equity modes of entry (e.g. strategic alliances) in markets with high-formal institutional distances, eschewing equity-based modes such as joint ventures, acquisitions or greenfield ventures (Brouthers and Nakos, 2004; Xu and Shenkar, 2002).

Overall, many of the research findings regarding institutional distance articulated above are logical and to be expected. However, distance is a rather generic concept and may not mean the same to all parties. For example, while the institutional distance between China and the USA is the same for both US firms and Chinese firms, does this distance have the same meaning to both the Chinese and US firms? In general, one would expect US firms to be more resourceful (i.e. have greater resources and capabilities) than Chinese firms. Thus, should US firms be better able to respond to and manage the institutional differences? Stated differently, is it more likely for US firms to navigate the institutional environment in China successfully than for Chinese firms to successfully navigate the institutional environment in the USA? Alternatively, one could argue that the institutional environment in China is more difficult to successfully navigate than the one in the USA. The institutional weaknesses in China are generally overcome by using informal norms and relationships to substitute for them. However, US firms are not accustomed to dealing with institutional weaknesses of the sort that exist in China and thus may be less able to use the informal relationships successfully. The questions that arise from these considerations suggest that moving from a weaker home institutional environment to a stronger host institutional environment is unlikely to be equal to moving from a stronger home institutional environment to a weaker host institutional environment even though the "distance" between the two is the same. Interestingly, this is only one of four potential "masks" of cultural distance explained by Tung and Verbeke (2010). The other three they suggest are the assumption of spatial homogeneity within each country, assumption that greater distance produces negative outcomes and the assumption that the effects of cultural distance are homogeneous across firms regardless of the firms' characteristics. The arguments presented herein combined with the conclusions from Tung and Verbeke's (2010) work suggest that the effects of cultural distance are likely more complex than suggested by the research. More research with extensive and integrative theoretical frameworks and richer research designs is required. Thus, we have more to understand about institutional distance and how it affects firms' strategies and implementation thereof.

The work on institutional distance assumes that firms only consider the host country institutional environment and how it differs from the home institutional environment but many firms' international strategy is more complex. For example, many MNEs focus their investments on foreign geographic regions which contain countries with similar institutions but with some variance across them.

Regional international strategies

For a number of years, Alan Rugman argued that the idea of "globalization" was a misnomer because most MNEs follow a regional international strategy, i.e., they invest in specific geographic regions and thus do not participate in the "global economy" *per se* (e.g. Rugman and Verbeke, 2004). Ghemawat (2003) suggested that firms often follow a semiglobalization strategy which is very similar to the regional strategy proposed by Rugman and his colleagues. Institutions are important in the regional or semiglobalization strategy. For example, Banalieva and Dhanaraj (2013) suggested that firms operating in home regions with greater institutional diversity were less likely to have a strong home region orientation. Arregle *et al.* (2013) found that firms engage in arbitrage attempting to leverage the institutional environments of countries within a region in order to gain the greatest benefits (e.g. access to resources, friendlier regulatory institutions). It follows then that regional institutional complexity could influence firm's semiglobalization strategies, i.e., affect their foreign direct investment decisions.

Essentially, regional institutional complexity presents both challenges and opportunities. When firms enter and operate in a particular region, they develop capabilities that can be deployed at low cost in other countries within the region because of their geographic proximity and similar institutions. Rugman and Verbeke (2004) refer to these as region-bound firm-specific advantages. A recent study by Arregle *et al.* (2016) found that there is an inverted U-shaped relationship between a region's institutional diversity (both formal institutional and cultural diversity) and MNE internationalization in that region. Moderate levels of diversity are best because they allow the firm to leverage their current advantages to enter and gain additional value from other countries in the region. However, high diversity and a larger number of countries increase the institutional complexity making it difficult for the firm to leverage its regional firm-specific advantages.

This work on regional strategies suggests that the research on institutional complexity and on institutional distance only provide a partial picture of the relationship between institutions and international strategy. In fact, perhaps the regional or semiglobalization perspective should be infused in the research on the effects of institutional complexity. Furthermore, the research on institutional distance must consider the regional strategies employed by the firms studied, or at least control for them.

Conclusions and future research questions

Mike Peng *et al.* (2009) proposed an institution-based view of firm strategy. The discussion herein clearly supports this approach. Undoubtedly institutions (formal and informal) have always been important for firm strategies (e.g. domestic institutions and strategies) but have become even more influential in firms' international and competitive strategies with the significant changes in the global economic, political and competitive landscapes. And, because the global environment is dynamic, the relationship between institutions and strategy evolves over time. This requires continuous study to ensure an accurate and timely understanding of the influence of institutions on firms' strategies. Additional research is also needed because our understanding of this relationship is rudimentary at best. Although there has been an increasing amount of research on institutions recently, the research on institutions and strategy is in its infancy. The examination of much more complex and encompassing research questions, development of richer theoretical frameworks and use of more sophisticated research designs are required to advance our understanding of this important relationship. Below is a list of some potentially important research questions that could advance our thinking in this area:

RQ1. What is the interrelationship between formal and informal institutions?

RQ2. How do formal and informal institutions affect firms' strategies (e.g. internationalization)? Are the effects of these institutions sequential or simultaneous?

RQ3. How do configurations of formal institutions affect firms' international strategies?

RQ4. What is the interrelationship between formal institutions at different levels (e.g. national, subnational)?

RQ5. How do multilevel institutions affect firms' international and competitive strategies? Are the effects sequential or simultaneous?

RQ6. Is the influence of institutional distance similar or different for firms moving from weak home institutional environments to stronger host institutional environments compared to firms moving from strong home institutional environments to weaker host institutional environments?

RQ7. What is the role of institutions in firms' regional international strategies?

RQ8. Are there regional institutional environments (e.g. European Union, Asia Pacific Economic Cooperation) and if so what is their influence on international strategies (home region firms and foreign firms entering in those regions)?

RQ9. What is the role of institutional distance in firms' regional international strategies?

RQ10. How does regional or international political discord influence the relationship between institutions and international strategy?

The above list of research questions is not exhaustive but is representative of the opportunities and needs for more research on institutions and international strategy. We also need to better understand how national and subnational institutions influence firms' domestic competitive strategies. For example, research in I/O economics and strategic management has shown a strong link between industry structure and other industry attributes (e.g. dynamism and munificence) and firms' competitive strategies. What role do national and subnational institutions play in this relationship? Given the intended roles for some of the key national institutions, we could assume that economic institutions might be used to constrain major fluctuations in supply and demand in industries. Additionally, some regulations are targeted for specific industries and thus regulatory institutions might constrain the availability and/or use of resources within certain industries. So, a multi-country study could examine the relationship between nations' formal institutions, industry dynamism and munificence and firm strategies within industries.

Some of the research questions listed above may require multilevel theoretical frameworks, multilevel research designs and special analytical tools to address them. Some of the other research questions may require longitudinal designs to better understand the evolutionary nature of the relationships examined. And, finally, we need to identify ways to capture the multiple types of subnational institutions that exist in order to accurately understand their effects.

While the challenges for understanding the complex relationship between institutions and international strategy may seem daunting, they can be overcome. This area of inquiry has become of primary importance in recent years; I believe that there is both substantial need and opportunity for quality scholarship to make critical contributions that advance our scholarly understanding of international strategy and also that contribute to more effective executives' decisions and national and international institutions and policies.

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