Inter-Organizational Networks and Relationships as Informal Institutions: Business Groups in Emerging Economies

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Abstract:
This paper investigates the implications of inter-organizational networks and relationships (as informal institutions) for firms’ strategic choices and performance in emerging economies, testing two key propositions of the institution-based view of strategy proposed by institutional strategy literature. First, informal constraints will play a larger role in emerging economies, reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and firms, where formal constraints are unclear or fail. Second, as formal market-supporting institutions are gradually implemented, a gradually reduced role of interpersonal relationships and more reliance on market-based capabilities will be observed. To test these two key propositions, business groups in multiple emerging economies are investigated, including China, Korea, Chile, India, Russia, Hungary, Poland, Czech Republic, and Indonesia. The investigation of business groups in multiple emerging economies confirms both key propositions. In essence, this paper tries to answer the question of ‘how institutions matter’, particularly in emerging economies.

Keywords: inter-organizational networks and relationships; informal institutions; business groups; emerging economies; institution-based view of strategy

I. INTRODUCTION

As emerging economies are increasingly considered as important markets in the global economy, more studies have focused on the differences between developed and emerging economies, particularly in terms of the institutional contexts. In other words, an increasing number of studies have investigated how different institutional environments in emerging economies affect firms’ behavior, strategic choices, and performance. McMillan (2007) indicates that when markets work smoothly in developed economies, the market-supporting institutions are almost invisible, however, when markets work poorly in emerging economies, the absence of strong market-supporting institutions is conspicuous. In essence, scholars have increasingly recognized that informal institutions significantly affect the strategy and performance of firms in emerging economies (e.g. Hoskisson et al., 2000; Wright et al., 2005). As Peng (2002) and Peng et al. (2008; 2009) argue, the institution-based view of strategy has emerged as one of the critical perspectives in strategic management as well as in international business research, complementing the traditional industry-based and resources-based view of strategies, particularly in terms of informal institutions in emerging economies.

This paper aims to test two key propositions of the institution-based view of strategy. First, this paper investigates how informal institutions, such as inter-organizational networks and relationships, affect firms’ strategic choices and performance in emerging economies. In other words, this paper examines the proposition that informal constraints will play a larger role in reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and firms in emerging economies where formal constraints are unclear or fail. Second, this paper also investigates the proposition that, as formal market-supporting institutions are gradually implemented, a gradually reduced role of interpersonal relationships and more reliance on market-based capabilities will be observed. To test these two key propositions of the institution-based view of strategy, this paper investigates, specifically, business groups in multiple emerging economies.

These two key propositions of the institution-based view of strategy have already been discussed by Peng et al. (2008; 2009). First, Peng et al. (2009, p.68) argue that: “while formal and informal institutions combine to govern firm behavior, in situations where formal constraints are unclear or fail, informal constraints will play a larger role in reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and
firms”. Second, Peng et al. (2009, p.69) further contend that “the more formal market-supporting institutions develop in emerging economies, the more we can expect a reduced reliance on informal network-based strategies and a heavier reliance on arm’s-length market-based strategies”. Therefore, this paper provides, in essence, concrete supports for the Peng et al.’s (2008; 2009) observations, investigating business groups in diverse emerging economies.

Non-market political strategies used in developed economies may be less effective in emerging economies where generally nontransparent political and regulatory environments exist (Peng et al., 2008). Thus, growing body of research has focused on emerging economies in the context of institutional uncertainty where informal institutions, such as social norms, trust, personal ties, and interpersonal networks and relationships, are critical in terms of facilitating cooperation (Chung, 2006; Kostova and Roth, 2002; Luo and Chung, 2005; Peng et al., 2008; Peng et al., 2009; Puffer and McCarthy, 2007; Zhu and Chung, 2014). But, the majority of studies on the impact of informal institutions on firms’ strategic choices and performance in emerging economies have mainly focused on the interpersonal and inter-organizational networks in China (particularly in connection with guanxi) which may serve as informal substitutes for formal institutional support (e.g. Fletcher and Fang, 2006; Peng and Luo, 2000; Park and Luo, 2001; Peng and Zhou, 2005). For instance, Peng and Luo (2000) demonstrate that managers’ ‘micro’ interpersonal relationships with top executives at other firms and with government officials in China help improve a ‘macro’ inter-organizational strategy of relying on the networks and alliances to grow a firm.

Some scholars argue that the proliferation and intensification of networks and relationships in China result from the Chinese culture (e.g. Redding, 1990). However, the guanxi-style inter-organizational networks and relationships, such as business groups, are also found in other emerging economies (e.g. Chile, Russia, Indonesia, Korea, the Czech Republic, Hungary, Poland, India, etc.). The inter-organizational networks and relationships (e.g. business groups) in these countries have influenced on firms’ strategic choices and performance particularly during these countries’ institutional transitions. Therefore, this paper investigates the inter-organizational networks and relationships not only in China but also in other emerging economies to test two key propositions of the institution-based view of strategy.

In sum, beyond Peng et al.’s (2008; 2009) observations, this paper tests two key propositions of the institution-based view of strategy, examining business groups in multiple emerging economies.

II. LITERATURE REVIEW

A. Institution-Based View of Strategy and Emerging Economies

Based upon the concept of the ‘rules of the game’, North (1991, p.97) defines institutions as “the humanly devised constraints that structure political, economic, and social interaction”. In specific, North (1991) identifies two different types of institutions, that is, formal rules (e.g. constitutions, laws, property rights) and informal constraints (e.g. sanctions, taboos, customs, traditions, codes of conducts). In a similar manner, Scott (2014, p.56) defines institutions as “regulative, normative, and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life”. In Scott’s definition, institutions can also be broadly classified as formal and informal ones. In other words, North’s division of institutions into formal and informal ones is complementary to Scott’s classification of institutions by three dimensions (i.e. regulative, normative, and cognitive) (Peng et al., 2009). Peng et al. (2008) illustrate that institutions govern societal transactions in the areas of politics, law, and society in connection with the issues such as corruption, transparency, economic liberalization, regulatory regime, ethical norms, and attitudes toward entrepreneurship.

While global economy is increasingly integrated, organizations are facing a significant challenge, that is, diverse institutional contexts across global markets which pose a different set of opportunities and threats. In the last decade, emerging economies have particularly assumed an increasingly prominent position in the global economy and the growing importance of emerging economies is reflected in the volume of research in recent
years. As emerging economies, whose institutional contexts are significantly different from those in developed economies, are explored more, scholars have increasingly recognized that informal institutions significantly affect the strategy and performance of firms in emerging economies (e.g. Hoskisson et al., 2000; Wright et al., 2005). As McMillan (2007) argues, when markets work smoothly in developed economies, the market-supporting institutions are almost invisible, however, when markets work poorly in emerging economies, the absence of strong market-supporting institutions is conspicuous. Consequently, the significant differences in institutional contexts between developed and emerging economies have forced scholars to examine these differences more, pushing the institutional approach to one of the critical perspectives in the international business strategy research.

The collection of papers in two journal special issues showed the rise of the institutional approach as a dominant perspective in strategy research on emerging economies (i.e. Hoskisson et al., 2000; Wright et al., 2005). In the Academy of Management Journal special issue on strategy research in emerging economies, edited by Hoskisson et al. (2000), seven out of thirteen papers rely primarily on the institutional approach (Peng et al., 2008). Hoskisson et al. (2000), thus, consider the institutional theory perspective as one of the most influential three perspectives on strategy in emerging economies (together with transaction cost economics/agency theory perspective and resource-based perspective). Hoskisson et al. (2000, p.252) note that “in the early stages of market emergence, institutional theory is preeminent in helping to explain impacts on enterprise strategies...because government and societal influences are stronger in these emerging economies than in developed economies”. But, Hoskisson et al. (2000, p.252) also note that as markets mature, the importance of institutional theory may decline. That is, as emerging economies become more developed, “transaction cost economics and, subsequently, the resource-based view are more important”. In the Journal of Management Studies special issue on strategy research in emerging economies, edited by Wright et al. (2005), seven out of eight papers are also institutional papers (Peng et al., 2008).

The papers in these two journal special issues investigate a variety of issues on strategies for emerging economies, including domestic strategies in emerging economies (Peng and Luo, 2000; White, 2000), business groups (Chang and Hong, 2000; Guillen, 2000; Khanna and Palepu, 2000; Wan, 2005; Yiu et al., 2005), foreign investment strategies (Child & Tsai, 2005; Chung and Beamish, 2005; Delios and Henisz, 2000; Hitt et al., 2000; Isobe et al., 2000; Meyer and Nguyen, 2005), privatization (Filatotchev et al., 2000; Uhlenbruck and De Castro, 2000), and internationalization strategies for firms based in emerging economies expanding abroad (Brouthers et al., 2005). The papers in these two journal special issues show that, as Peng et al. (2008) point out, the institutional theory becomes the most frequently drawn upon theoretical tool to better understand the unfolding competition in emerging economies.

Marquis and Raynard (2015) categorize, broadly, the institutional strategies into three dimensions: relational, infrastructure-building, and socio-cultural-bridging. Among these three dimensions, this paper examines relational strategies in emerging economies more in detail in the following section, because relational strategies primarily concern the inter-organizational networks and relationships.

Infrastructure-building strategies focus on the importance of commercial, technological, and physical infrastructures to facilitate market interactions and transactions, since the absence or limitation of such infrastructure causes a number of challenges to firms (Marquis & Raynard, 2015). As Ault and Spicer (2014) point out, where key market information is not readily available or reliable, and formal rules are not established or well defined, firms face additional uncertainty and challenges. Thus, a number of researchers have studied on the elements of institutional infrastructure needed to facilitate commercial activities in emerging economies where infrastructure (i.e. information) is not present or marginally developed (e.g. Mair et al., 2012; Uzo & Mair, 2014). A number of researchers have also studied on the underdeveloped commercial and physical infrastructures in emerging economies, such as inadequate communication technology, transportation infrastructure, power generation capabilities, and distribution channels (e.g. Hitt et al., 2000; Miller, 1998; Luthra et al., 2005). In essence, firms are engaging in collective action in order to overcome problems associated with a lack of adequate or reliable information, or underdeveloped physical and commercial infrastructures (Marquis and Raynard, 2015). The use of existing global standards is another type of
infrastructure-building strategy in emerging economies (Guler et al., 2002). Global standards have attracted more international attention recently as global consumers increasingly focus on labor and environmental conditions (Bartley, 2003; 2007; Marquis and Raynard, 2015; Tarnovskaya, 2012). However, some scholars raise questions about whether adopting these global standards make it easier for firms in emerging economies to only comply with global norms symbolically (e.g. Marquis and Qian, 2014; Okhmatovskiy and David, 2014; Tilcsik, 2010). Lastly, consumer tastes and preferences in emerging economies may be different from those in developed economies (or home countries). Thus, firms must first establish the legitimacy of an entire product category in order to market effectively their specific products in emerging economies (Marquis and Raynard, 2015).

As Okhmatovskiy (2010, p.1039) describes, market transactions “do not happen in a vacuum, but in specific social, cultural, and political context”. Through socio-cultural bridging strategies, as Marquis and Raynard (2015) argue, firms both attend to and shape the socio-cultural and demographic characteristics of their competitive environment, since firms are not merely subject to socio-cultural and demographic issues, but also active participants. In a similar perspective, Khanna et al. (2005) maintain that many multinationals are either powerful enough to alter the context in which they operate, or their products or services are valued enough to force dramatic changes in local markets. In emerging economies, firms are faced with diverse social-cultural and demographic issues. Some scholars point out that demographic challenges, such as a young workforce, lack of available skilled workers, and increasing urbanization, are especially problematic in emerging economies (Hiatt and Sine, 2014; Mahon et al., 2004). To tackle these issues, firms have heavily invested in employee training and development, brought over experts and managers from their home countries, and made location decisions based on the availability of skilled labor (Arnold and Quelch, 1998; Kostova and Roth, 2002; Puffer et al., 2010). There is growing empirical evidence that establishing a core group of local talent is critical to understanding local conditions and cultural norms (Marquis and Raynard, 2015). London and Hart (2004, p.364) emphasize the need for social embeddedness, that is: “the ability to create competitive advantage based on a deep understanding of and integration with the local environment”. The enduring legacies of Soviet-style market economies and communist regimes, particularly in transition economies, are also critical aspects in terms of socio-cultural bridging strategies (Kriauciuunas and Kale, 2006; Li et al., 2013; Pop-Eleches, 2007). For example, under these legacies, there are still social expectations from both the labor force and the public that firms should provide healthcare, education, and accommodation for employees and their families (Han et al., 2014; Zu and Song, 2009). A greater appreciation of these legacies is critical for understanding how local norms, values, and expectations continue to enable and constrain firms’ behavior and strategic action in emerging economies (Han et al., 2014). In essence, responding appropriately to socio-cultural expectations is critical for gaining access to resources, legitimacy, and social approval (Oliver, 1991; Pfeffer and Salancik, 1978).

B. Inter-Organizational Networks and Relationships in Emerging Economies: Focusing on China

Among three dimensions of the institutional strategies above, relational strategies concern the inter-organizational networks and relationships in emerging economies. The basic argument of relational strategy is that effective management of relationships with both internal and external actors enables a firm not only to enhance its competitive position in the market, but also to ensure the stability and certainty of its resource exchanges (Marquis and Raynard, 2015). But, as Peng et al. (2008) point out, while some firms in developed economies actively seek to shape the ‘rules of the game’ in their favor, such political strategies may be less effective in emerging economies because of generally non-transparent political and regulatory environments. In this regard, a growing body of research has emphasized the importance of interpersonal networks, social capital, and informal institutions in emerging economies to deal with institutional uncertainty and to facilitate cooperation (Chung, 2006; Kostova and Roth, 2002; Luo and Chung, 2005; Peng et al., 2008; Peng et al., 2009; Puffer and McCarthy, 2007; Zhu and Chung, 2014). For example, Peng and Luo (2000) found that managers have heavily relied on interpersonal networks, such as alliances and inter-organizational agreements, as

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informal substitutes for weak market structures in transition economies. Studies also show that the integration of corporate political strategies with market strategies in emerging economies is critical because the boundaries between government and business, oftentimes, are not clear in these economies (Keim and Hillman, 2008; Li et al., 2013; Sun et al., 2012, Wang, 2014). Puffer et al. (2010) found that entrepreneurs in Russia and China relied heavily on informal connections and relationships (i.e. ‘blat’ in Russia and ‘guanxi’ in China) to reduce uncertainty and to facilitate business transactions.

However, a growing body of research also exhibits that close ties with the government and other political actors in emerging economies are associated with risks. For instance, direct ties to the government may expose a firm to strong pressures to divert its resources to advance political goals and agendas (Marquis and Qian, 2014; Okhmatovskiy, 2010). In addition, the stakeholder management approach to relational strategy based on developed economies may require adjustments for emerging economies. In other words, the strategy of balancing the claims of primary stakeholder groups may not be effective or feasible in emerging economies (Marquis and Raynard, 2015). While a positive relationship can be assumed in developed economies concerning the relationship between corporate social and financial performance, the reverse can also be true in emerging economies because a local government may focus more on economic development and job creation than corporate social responsibility.

Peng and Luo (2000) demonstrate that managers’ ‘micro’ interpersonal ties with top executives at other firms and with government officials in China help improve ‘macro’ organizational performance. The authors also suggest that this micro-macro link differs among firms based on ownership types, business sectors, size, and industry growth rates. But, while managerial ties are necessary for good performance, other traditional strategy variables are still necessary to drive performance. Peng and Luo (2000) show that: (1) ties with government officials are more important than ties with managers at other firms; (2) the impact of personal ties with managers at other firms on market share is likely to be stronger for firms in low-growth industries; (3) although managerial ties are important, a firm also needs to have capabilities, such as quality and advertising, for better firm performance; and (4) it is easier for managerial ties to have an impact on market share than on return on assets.

Park and Luo (2001, p.455) define guanxi as “the concept of drawing on a web of connections to secure favors in personal and organizational relations”. While guanxi is embedded in every aspect of Chinese social life, firms, in terms of guanxi cultivation, show different needs and capacity. Park and Luo (2001) develop an integrative framework theorizing guanxi utilization and examine the impact of guanxi on firm performance, particularly on sales growth and on net profit growth. The authors found that while institutional, strategic, and organizational factors are critical determinants of guanxi with competitive forces, only institutional and strategic factors are significant for guanxi utilization with government authorities. In essence, Park and Luo (2001) argue that guanxi can lead to higher firm performance, but is limited to sales growth with little impact on profit growth. The authors further argue that guanxi benefits market expansion and competitive positioning, but it does not enhance internal operation.

Fletcher and Fang (2006) note that there are two basic approaches, broadly, to study culture and social behavior, that is: etic (concerns with identifying universal dimensions that underlie cultural differences) and emic (holds that attitudes and behaviors are expressed in a unique way in each culture). The authors argue that culture, in Asian markets, can be better understood through cultural groupings (e.g. ethnic grouping) than through politically defined and artificially created national boundaries. In addition, the assessment and comparison of cultural differences and similarities in Asia can be examined by an enlarged emic approach. Fletcher and Fang (2006) maintain that a possible Asian cultural dimension is Yin Yang (Fang, 2003) or ‘embracing paradox (if an emic-embedded approach to Asian environments is applied) and the Yin Yang approach to life is not reflected in the etic theory of culture.

Peng and Zhou (2005) note that institutions have multiple dimensions, such as political, legal, and economic ones, and they are closely connected and mutually reinforcing. Thus, institutional transitions may manifest diverse patterns due to different dimensional changes at different speeds. Peng and Zhou (2005), focusing on the intermediate phase of institutional transitions in emerging economies in Asia, argue that as institutional
transitions unfold, strong-tie-based networks, instead of being phased out, are being transformed into weak-tie-based networks in terms of network strength. The authors also argue that, in terms of network content, the various scale and scope of institutional transitions shape the content of different networks which focus on business-to-government and business-to-business relationships. In essence, Peng and Zhou (2005) suggest that networks not only differ in strength but also in content. Also, the evolution of networks is driven by different dimensions of institutional transitions governing business-to-government and business-to-business relationships.

III. RESEARCH METHODOLOGY

As discussed above, this paper aims to test two key propositions of the institution-based view of strategy. To test these two key propositions, an extensive literature review was performed, including business groups in multiple emerging economies such as China, Korea, Chile, India, Russia, Hungary, Poland, Czech Republic, and Indonesia.

In specific, beyond summarizing the recent research on the institution-based view of strategy, inter-organizational networks and relationships (as informal institutions), and business groups in multiple emerging economies, this paper provides an integration of literatures and offers an integrated framework, investigating not only China but also other emerging economies in terms of informal institutions (i.e. business groups). In essence, this piece is a conceptual paper, focusing on integration and proposing new relationships among constructs (i.e. inter-organizational networks and relationships, such as business groups, as informal institutions; emerging economies; firms’ behavior, strategic choices, and performance).

As Gilson and Goldberg (2015) point out, conceptual papers should take a problem-focused approach and address what’s new question thoroughly. In addition, Gilson and Goldberg (2015, p.128) further describe that “unlike a theory paper, conceptual pieces need not propose new theory at the construct level, but rather they seek to bridge existing theories in interesting ways, link work across disciplines, provide multi-level insights, and broaden the scope of our thinking”. In this regard, this paper tries to bridge the existing theories of the institution-based view of strategy particularly in connection with emerging economies and to broaden the scope of research on the inter-organizational networks and relationships to encompass diverse emerging economies beyond China.

A good conceptual paper may also build theory by offering propositions regarding previously untested relationships (Gilson and Goldberg, 2015). Although this paper does not build new theories, it tests two key propositions of the institution-based view of strategy, offering a bridge between validation and usefulness.

IV. RESEARCH QUESTIONS

Through the institutional literature, scholars have studied both formal institutions (e.g. laws, rules, regulations) and informal institutions (e.g. cultures, norms, values, ethics). As described above, North’s (1991) division of institutions into formal and informal ones is complementary to Scott’s (1995; 2008; 2014) classification of institutions by three dimensions (i.e. regulative, normative, and cognitive). In other words, both North (1991) and Scott (1995; 2008; 2014) support the argument that research on institutions needs to investigate both formal and informal components.

This paper aims to test two key propositions of the institution-based view of strategy. First, this paper investigates how informal institutions, particularly in emerging economies, such as inter-organizational networks and relationships, affect firms’ strategic choices. In other words, this paper examines the proposition that informal constraints will play a larger role in reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and firms in emerging economies where formal constraints are unclear or fail. Second, this paper also investigates the proposition that, as formal market-supporting institutions are gradually implemented, a gradually reduced role of interpersonal relationships and more reliance on market-
based capabilities will be observed. To test these two key propositions of the institution-based view of strategy, this paper examines, specifically, business groups in multiple emerging economies.

As mentioned earlier, these two key propositions have already been discussed by Peng et al. (2008; 2009). Based on the complementary approach to institutions and, also, extending this complementary approach to strategic management, Peng et al. (2009) introduced two important perspectives on the institution-based view of strategy. First, Peng et al. (2009, p.68) argue that: “while formal and informal institutions combine to govern firm behavior, in situations where formal constraints are unclear or fail, informal constraints will play a larger role in reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and firms”. Second, Peng et al. (2009, p.69) further point out that “the more formal market-supporting institutions develop in emerging economies, the more we can expect a reduced reliance on informal network-based strategies and a heavier reliance on arm’s-length market-based strategies”. Beyond Peng et al.’s (2008; 2009) observations, this paper tries to test these two key propositions of the institution-based view of strategy, examining business groups in multiple emerging economies.

V. IMPLICATIONS OF THE INSTITUTION-BASED VIEW OF STRATEGY FOR EMERGING ECONOMIES

Considering the development of new institutionalism in the social sciences (Oliver, 1997; Peng et al., 2008; Peng et al., 2009; Scott, 1995; 2008; 2014), both strategic management and international business scholars have increasingly become aware of institutions as more than background conditions. The traditional industry-based and resource-based views of strategy are criticized for not actively considering the formal and informal institutional environments, assuming institutions just as ‘background’, that provide the context of competition (Peng, 2000; Peng et al., 2008; Peng et al., 2009). Peng et al. (2008) point out that the industry-based and resource-based views’ lack of attention to context is primarily attributed to the research on competition in the U.S., where a relatively stable, market-based institutional framework can be assumed. In other words, while both the industry-based and resource-based views have dealt with institutional environments, they have mainly focused on the 'task environments', such as economic variables (e.g. market demand, changes in technology). Namely, studies based on the industry-based and resource-based views have rarely looked beyond the task environments to examine the interaction among institutions, organizations, and strategic choices (Narayanan and Fahey, 2005; Peng et al., 2008; Teegen et al., 2004).

It is very clear that treating institutions as background will not move strategy research forward much, particularly in connection with emerging economies. In order to consider the significant differences in institutional frameworks between developed and emerging economies, scholars should pay more attention to the institutional factors in addition to the traditional industry-based and resource-based factors. As described earlier, McMillan (2007) indicates that when markets work smoothly in developed economies, the market-supporting institutions are almost invisible. In contrast, when markets work poorly in emerging economies, the absence of strong formal institutions is conspicuous. Thus, scholars should be much more conscious of the relationship between institutions and firms, particularly in emerging economies. Moreover, some scholars argue that treating institutions as just background is insufficient for deep understanding of firms’ strategic behaviors (or choices) and performance even in developed economies (Clougherty, 2005; Ingram and Silverman, 2002; Oliver, 1997; Scott, 2008; 2014).

Peng et al. (2008, p.923) contend that “institutions directly determine what arrows a firm has in its quiver as it struggles to formulate and implement strategy and to create competitive advantage”. The institution-based view of strategy, treating institutions as independent variables, focuses on the interaction between institutions and firms. In addition, the institution-based view of strategy considers, as Peng et al. (2009) describe, firms’ strategic choices as the outcome of the interaction between institutions and firms. In specific, firms’ strategic choices are not only driven by industry conditions and firm capabilities, but also a reflection of the formal and informal constraints of a particular institutional framework that firms confront (Peng et al., 2009). In essence, the institution-based view of strategy helps scholars answer the question of ‘how institutions matter’,
particularly in the context of emerging economies. Testing two key propositions of the institution-based view of strategy, this paper also tries to answer the question of ‘how institutions matter’, particularly in connection with informal institutions, in emerging economies.

VI. SIGNIFICANCE OF INFORMAL INSTITUTIONS IN EMERGING ECONOMIES

Although China has shown sustained economic growth for the last three decades, some scholars have questioned China’s strong economic growth under its relatively weak formal institutions. For instance, Boisot and Child (1996) question that how China could achieve such rapid rates of growth, while retaining underdeveloped formal institutional structures. In response to this question, Peng et al. (2008, p.927) suggest that “interpersonal networks (guanxi) cultivated by managers in the society may serve as informal substitutes for formal institutional support”. Peng et al. (2008:927) further suggest that “micro, interpersonal relationships among managers are translated into a macro, inter-organizational strategy of relying networks and alliances to grow the firm, thus leading to a micro-macro link”. This Peng et al.’s (2008) suggestion can be considered as a key institutional proposition and is also equivalent to the first proposition tested by this paper, that is: although both formal and informal institutions shape firms’ strategic choices, in situations whereby formal institutions are weak, informal institutions, such as inter-organizational networks and relationships, rise to play a larger role in terms of firms’ strategic choices and performance (Peng et al., 2009).

Although the term guanxi represents the unique Chinese culture which emphasizes connections to secure favors in personal and organizational relations, informal institutional environments similar to Chinese guanxi-based inter-organizational networks and relationships are also found in other countries, particularly in emerging economies (e.g. business groups). Thus, this paper investigates some emerging economies which exhibit informal institutional environments similar to China (particularly in terms of inter-organizational networks and relationships) in order to examine the implications of informal institutions for firms in emerging economies. Especially, this paper investigates business groups, as informal institutions, in several emerging economies. This investigation of business groups tests the first proposition of the institution-based view of strategy of this paper. Moreover, this investigation of business groups also tests the second proposition of the institution-based view of strategy of this paper, that is: as formal market-supporting institutions are gradually implemented, a gradually reduced role of interpersonal relationships and more reliance on market-based capabilities will be observed.

But, informal institutions, such as inter-organizational networks and relationships, are not only relevant for emerging economies but also relevant for developed economies in terms of firms’ strategic choices and performance. Peng et al. (2009, p.68) argue that “even in developed economies, formal rules make up only a small (though important) part of institutional constraints, and informal connections are pervasive”. Peng et al. (2009, p.68) further contend that “just as firms compete in product markets, firms also fiercely compete in political markets characterized by informal relationships”.

VII. INTER-ORGANIZATIONAL NETWORKS AND RELATIONSHIPS IN EMERGING ECONOMIES: BUSINESS GROUPS AS INFORMAL INSTITUTIONS

A. Korea

While their characteristics may be different from country to country, business groups are not specific to Korea and they are widespread in many emerging economies. This phenomenon can be explained as a response to market imperfections (Leff, 1978). In other words, business groups replace poorly performing or nonexistent economic institutions taken for granted in developed economies (Chang and Hong, 2000). Chang and Hong (2000) argue that business groups, in some cases, offer efficient forms of governance since firms affiliated with groups tend to produce higher profitability than independent firms in the same countries.
Chang and Hong (2000, p.429) define a business group as “a gathering of formally independent firms under the single common administrative and financial control of one family” and examine the economic performance of the firms associated with the Korean business groups (i.e. chaebols) by addressing group-wide resource sharing and internal business transactions. The authors argue that two factors mainly influenced the emergence of chaebols in Korea. First, the market imperfection faced by Korean firms encouraged firms to pursue internalization. Second, while pursuing aggressive, export-oriented development policy, the Korean government provided various supports and subsidies for business groups, distorting further the market mechanism. Chang and Hong (2000, p.431) indicate that “ shaped by market imperfection and government intervention, the Korean business groups have become both extremely diversified and highly integrated”.

Chang and Hong’s (2000) study shows that group-affiliated firms in Korea benefit from group membership through sharing intangible and financial resources with other member firms. The study also shows that various forms of internal business transactions, such as debt guarantee, equity investment, and internal trade, are extensively used among group-affiliated firms in Korea for the purpose of cross-subsidization. The authors argue that the Korean business groups are generating real economies of scale and scope. In general, the Korean business groups are efficient economic organizations which can minimize transaction costs caused by market inefficiencies prevalent in emerging economies. The study on the Korean business groups by Chang and Hong (2000) confirms the first proposition of the institution-based view of strategy of this paper.

B. Chile

Khanna and Palepu (2000) investigate the variation in the extent to which firms benefit from their affiliation with Chilean business groups in the 1988-1996 period. The authors point out that the central theoretical issue of interest concerns the effects of the institutional context on the relative values of different organizational forms. Chile offers an ideal setting for analysis, because it has experienced extensive and early changes in its institutional context especially in terms of market development. Khanna and Palepu (2000) examine the changes in value creation by Chilean business groups between the late 1980s and the mid 1990s. In specific, the authors are interested in the changes in performance effects of business group affiliation as institutional context changes. A number of studies emphasize that institutions affect economic outcomes (e.g. Hoskisson et al., 2000; Marquis and Raynard, 2015; North, 1991; Peng et al., 2008; 2009; Peng and Zhou, 2005). In emerging economies, a variety of market failures exist mainly because of an inefficient institutional context (particularly because of an imperfect formal institutional environment), resulting in more transaction costs. Thus, Khanna and Palepu (2000, p.269) point out that “an enterprise can often be more profitably pursued as part of a large diversified business group that can act as an intermediary between individual entrepreneurs and imperfect markets”.

Khanna and Palepu (2000) found that, in Chile, affiliates of the most extensively diversified business groups outperformed focused unaffiliated firms in the early years of their data. This result is in contrast to the observation in developed economies. The authors also found that, as context changes, the benefits of group affiliation change. In other words, there is stronger evidence of the decline in the extent of non-diversification-related group benefits. Since the passage of time is correlated with the emergence of an array of specialized intermediaries, Khanna and Palepu (2000) conjecture that such decline in benefits is caused by a lowering in the costs of transacting through the market. Therefore, the study on the Chilean business groups by Khanna and Palepu (2000) confirms both the first and the second propositions of the institution-based view of strategy of this paper.

C. India
Kedia et al. (2006, p.559) define a business group as “a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action”. The authors note that business groups tend to fill up the institutional voids created by imperfect capital, labor, and product markets. Further, group ties enable affiliated members to reap distinct benefits normally impossible on the part of non-group firms.

Kedia et al. (2006, p.559) examine the evolution and transformation of Indian business groups over two economic eras: pre-reform era (pre 1991) and reform era (post 1991). In order to understand institution-influenced Indian business groups, Kedia et al. (2006) introduce the concept of ‘institutional relatedness’. That is, a dense network of ties with dominant institutions will provide business groups with three non-market forms of capital to leverage: social, political, and reputational.

But, while a substantial number of business groups have continued to exist and contributed to Indian economy for decades, these business groups’ behavioral and performance patterns have been influenced by the changes in Indian national institutional framework. In specific, the pre-reform era in India, for the most part, is associated with market deficiency, the lack of well-functioning financial, product, and labor markets. Namely, “Indian economic structure was characterized by near-absence of efficient markets” (Kedia et al., 2006, p.563). This market imperfection posed substantial problems for firms. However, as Kedia et al. (2006) point out, a well-diversified group structure could create more value than a stand-alone firm in such conditions.

In contrast, around 1990 and thereafter (reform era), several economic reforms (including liberalization and deregulation) were initiated by the Indian central government and these reforms brought changes in the institutional frameworks for business groups in India (Kedia et al., 2006). Due to the changes in economic and business environments, the Indian business groups were exposed to significantly different business environment, but, the changes presented the business groups with increased opportunities for relatively unregulated growth and increased diversification (Kedia et al., 2006). In response to these institutional changes, the Indian business groups reexamined their earlier strategies and pursued restructuring activities. This Indian business groups’ response to the institutional changes was similar to the response in the developed economies. In other words, in the developed economies (particularly in the U.S.), there was increasing evidence that although unrelated diversification added value in the earlier decades, it did not help firms create value in the later decades (Berger and Ofek, 1995). Thus, firms took extensive restructuring in the 1980s and 1990s.

The findings on Indian business groups by Kedia et al., (2006) confirm both the first and the second propositions of the institution-based view of strategy of this paper.

D. Russia

Puffer and McCarthy (2007) investigate the role of the state and the type of capitalism that is evolving in Russia. Puffer and McCarthy (2007, p.1) view this system “as consisting of three forms of network capitalism that coexist in this transition economy – market, oligarchic, and siloviki – and the relationships among them, all existing within the pervasive environment of the Russian state”. Puffer and McCarthy (2007: 1) argue that “the Russian economy will continue to be based for some time on the cognitive institutional pillar rather than the regulative pillar”.

The dissolution of the centrally planned economy also saw the dismantling of institutions, causing chaos throughout the entire economic system. The lack of institutional development was a major cause of Russia’s unstable environment and the resulting reliance on informal relationships and traditional values (Puffer and McCarthy, 2007). Particularly, the authors point out that Russia’s increasing political stability has not produced, still, a codified or diffused information system as well as a supporting institutional system. Consequently, Russia still depends on a ‘clan organizational form of capitalism’ with the reliance on networks.

Specifically, in clans, transactions are based primarily on personal relationships rather than formal rules, leading to networks to accomplish business objectives (Puffer and McCarthy, 2007). Puffer and McCarthy (2007, p.3) further argue that “clans permit a local and personalized cognitive type of institutional order”. This cognitive institutional environment, rather than formal, rule-based regulative institutional environment, allows
networks to thrive in Russia. Puffer and McCarthy (2007) view this Russia’s institutional environment as ‘a system of state-managed network capitalism’. The authors predict that Russia will continue to develop its state-managed, network capitalism.

The findings on Russia’s state-managed, network capitalism by Puffer and McCarthy (2007) confirm the first proposition on the institution-based view of strategy of this paper.

E. Central Europe: Hungary, Poland, and Czech Republic

Spicer et al. (2000) investigate the debate over the efficacy of mass privatization programs in Central Europe by examining the institutional foundations of privatization theories. While advocates of rapid mass privatization emphasize the need to destroy old institutions rapidly in order to create new markets quickly, Spicer et al. (2000, p.631) argue that “rapid mass privatization destroys the old system of central planning but does not create the institutional foundations by which to achieve substantive restructuring in the post-privatization environment”. Spicer et al. (2000: 631) further argue that “a successful program of gradual reform process allows for the formation of new institutions to evolve gradually from the inherited network ties and social relations that defined the initial economic landscape of post-communist societies”.

The research on networks and social embeddedness of firms, according to Spicer et al. (2000), grows out of a basic observation that firms and individuals operating in turbulent environments often do not resort to bureaucratic or contractual methods to promote cooperation. This view reflects the prevalence of informal networks of local firms and political actors in communist economies, although the patterns of network organizations and identification of network members varied due to different national histories. In essence, the authors agree with Peng and Heath (1996) in that the lack of formal institutional mechanisms to support impersonal market exchange in post-socialist economies makes the role of informal agreements and relations even more important, leading many firms to pursue network strategies to grow under these institutional environments.

The findings on privatization in Central Europe by Spicer et al. (2000) confirm the first proposition on the institution-based view of strategy of this paper.

F. Indonesia

Dieleman and Sachs (2006) conducted an in-depth analysis of the strategy of the Salim Group, an ethnic Chinese conglomerate that migrated from China to Indonesia in 1938. They found that the strategy of the firm move from the relationship based model to the market-based model.

Dieleman and Sachs’s (2006) study is based on Peng’s (2003) proposition. Namely, as emerging economies undergo institutional transitions, firms increasingly adopt Western-style market-driven strategies, moving away from business transactions embedded in strong personal and political networks. Dieleman and Sachs (2006) postulate that there is a continuum between the relationship-based business model and the market-based model. In other words, none of these models appears in their pure form among Asian conglomerates and firms, depending on the situation, oscillate between these models at an irregular rate. Dieleman and Sachs (2006, p.531) propose that “the relationship-based strategy cannot be successful if it were not for the simultaneous pursuit of the market-based model”. Dieleman and Sachs (2006, p.532) further propose that “evolution from relationship- to market-based strategy is facilitated by generational transition in management”.

Dieleman and Sachs (2006) conclude that while both models are essential for a firm’s success, the relationship-based model seems to be more important for the firm’s early times and the market-based model becomes more significant during the recent institutional changes.

The findings on the strategy of the Salim Group by Dieleman and Sachs (2006) confirm the second proposition of the institution-based view of strategy of this paper.

VIII. CONCLUSIONS
Both strategic management and international business scholars have increasingly become aware of institutions as more than background conditions. The traditional industry-based and resource-based views of strategy have not actively considered the formal and informal institutional environments and they assumed institutions just as ‘background’ that provide the context of competition. However, it is very clear that treating institutions as background will not move strategy research forward much, particularly in connection with emerging economies. Scholars should pay more attention to the institutional factors in addition to the industry-based and resource-based factors in order to consider the significant differences in institutional contexts between developed and emerging economies.

Two key propositions of the institution-based view of strategy are tested through this paper. Especially, this paper investigates diverse business groups in multiple emerging economies in order to examine the implications of the inter-organizational networks and relationships (as informal institutions) for firms’ strategic choices and performance in emerging economies. This investigation confirms both key propositions of the institution-based view of strategy. That is, this paper confirms that: first, informal constraints (such as business groups) will play a larger role in reducing uncertainty, providing guidance, and conferring legitimacy and rewards to managers and firms in emerging economies where formal constraints are unclear or fail (the business groups in Korea, Chile, India, Russia, Hungary, Poland, and Czech Republic confirm the first proposition) and; second, in emerging economies, as formal market-supporting institutions are gradually implemented, a gradually reduced role of interpersonal relationships and more reliance on market-based capabilities will be observed (the business groups in Chile, India, and Indonesia confirm the second proposition).

As indicated earlier, these two key propositions of the institution-based view of strategy have already been discussed by Peng et al. (2008; 2009). In essence, this paper aims to test these two key propositions beyond Peng et al.’s (2008; 2009) observations, examining business groups in multiple emerging economies. In this perspective, this paper contributes to the current literature on the institution-based view of strategy especially in terms of emerging economy. In addition, testing these two key propositions, this paper also tries to answer the question of ‘how institutions matter’, particularly in connection with informal institutions in emerging economies.

Some scholars (e.g. Boisot and Child, 1996) question that how China could achieve such rapid rates of growth, while retaining underdeveloped formal institutional structures. Peng et al. (2008) suggest that interpersonal networks in China (i.e. guanxi) may serve as informal substitutes for formal institutional support. In fact, a number of scholars (e.g. Fletcher & Fang, 2006; Park & Luo, 2001; Peng & Luo, 2000; Peng & Zhou, 2005) have suggested that the proliferation and intensification of the inter-organizational networks and relationships in China is due to the Chinese culture. However, as this paper demonstrates, a number of emerging economies, in addition to China, are sharing very prominent informal institutional context of the inter-organizational networks and relationships, such as business groups. In other words, a number of emerging economies are sharing very similar Chinese guanxi-style culture.

Although defining the relationship between national cultures and institutions is beyond the scope of this paper, we can consider culture as “a substratum of institutional arrangement” (Hofstede et al., 2002, p.800). More specifically, we can consider culture as “a part of informal institutions in the environment that underpin formal institutions” (Peng et al., 2008: 922).

Lastly, Peng et al. (2009, p.68) describe that, in developed economies, “just as firms compete in product markets, firms also fiercely compete in political markets characterized by informal relationships”. Japanese firms, particularly, are known for employing a specific type of the inter-organizational networks and relationships, that is, keiretsu. Therefore, having the impression that only emerging economies are relying on informal institutions is wrong. Informal institutions are not only relevant for emerging economies but also relevant for developed economies in terms of firms’ strategic choices and performance.

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