WHAT YOU SEE IS NOT WHAT YOU GET: INSTITUTIONAL CONFLICT AND MNE SUBSIDIARY SURVIVAL

The issue of MNE subsidiary survival is approached through a new theoretical argument that examines the presence of institutional conflicts in host countries. A large longitudinal database of Japanese subsidiaries is used to examine how such underlying conflicts would result in quite a few unpleasant surprises for MNEs.

“People are strange, when you’re a stranger”- The Doors.

The study of institutions and organizations has occupied researchers within the domains of sociology and economics for well over a century (Scott, 2001). One aspect of this research deals with the complexity of the institutional environment and its effects on organizations.

A growing stream of research in the business literature deals with the interaction between institutions and organizations. In particular, international business issues provide an interesting setting for exploring the interaction between organizations and complex institutional environments.

In this paper, I seek to examine what happens to MNE subsidiaries in countries that provide possibilities of high institutional complexity and conflict. This study is thus positioned at the confluence of two streams of research: studies of institutional complexity and conflict in general, and international business research dealing with the effects of institutional environments on MNE subsidiaries.

Theoretical Background

Institutional environments that organizations operate in are necessarily complex. A seminal attempt to delineate and highlight the complexity of institutional environments was undertaken by Scott (Scott, 2001). In this view, institutions can be classified into three different “types”, referred to by Scott as “pillars”: regulative, normative and cultural-cognitive. Regulative institutions include the overt rules and regulations governing organizational actions and behavior, while cultural-cognitive institutions include the less overt “mental models” that are an integral part of people and societies.

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Though the possibility of institutional conflicts as a result of the general complexity of the institutional environment is acknowledged in some studies (Kostova and Roth, 2002; Kostova and Zaheer, 1999; Hybels, 1995), yet a detailed treatment of the impact of such institutional conflict on organizations operating in such an environment is missing.

Within international business studies, the institutional environment and its impact on MNE subsidiaries is an area of growing interest (Delios and Beamish, 1999; Delios and Henisz, 2000; Henisz and Delios, 2001). However, different types of institutions, particularly ‘cultural-cognitive’ ones, are generally considered in isolation from other types such as ‘regulative’ ones (Hofstede, 1983; Kogut & Singh, 1988). The notion of conflict between broadly different ‘types’ of institutions is thus generally not explored in such studies.

My work seeks to add to the growing body of literature in international business studies that deals with the institutional environment. I bring in the notion of institutional conflicts in host countries and attempt to highlight its importance as a predictor of MNE subsidiary fortunes. While earlier studies have looked at political instability, economic crises, cultural distance and so forth to examine MNE subsidiary fortunes in host countries, my theoretical arguments are different as I consider the direct impact of possible institutional conflicts.

Hypothesis Development

My concern is with institutional environments at the level of countries and societies. While national culture studies (Hofstede, 1983; Kogut & Singh, 1988) focus on one “type” of institution, my aim is to look at the interplay and possible conflict between more than one “type” of institution. I thus attempt to focus on the importance of variance between different broad types of institutions (e.g. regulative vis-à-vis cultural-cognitive institutions), rather than within a particular broad institution type (e.g. differences in cultures across countries).

At the level of the countries and societies, the interplay between different types of institutions has been studied most prominently by North (North, 1986; 1990; 1991; 1994). Among North’s central contentions is that overt regulative and economic institutions evolve out of a complex interplay with the cultural-cognitive institutions in a society. However, institutional change is generally overwhelmingly incremental and path dependent, particularly that which relates to changes in the “mental models” of members of a society (North, 1991).

Thus, unless the overt regulative institutional framework has co-evolved with the cultural-cognitive institutions of members of a society, the existing regulative institutions would not be in broad congruence with the cultural-cognitive ones. There would thus be variance between these institution types. Societies and countries that lack this congruence to a considerable degree are prone to the existence of institutional conflicts between these broadly different types of institutions.

This issue would be of importance to firms seeking to establish subsidiaries in overseas countries. Following Dunning’s Ownership, Location and Internalization (OLI) paradigm, I consider that in making the decision to go international, the “Location” factor is an important one for MNEs, along with the Ownership and Internalization aspects (Dunning, 1998).

My specific focus is on the “Location” aspect, and I attempt to show that based on an understanding of the possible existence of institutional conflicts, one can predict better survival chances for MNE subsidiaries in some countries vis-à-vis others.
I contend that the representative-ness of a country’s government is a good indicator of the likelihood of the existence or absence of institutional conflicts. Further, the broad institutional conflicts I am interested in are more likely to be obscured from MNEs in countries with less representative governments. This results in an unpleasant surprise awaiting MNEs that establish subsidiaries in such countries, wherein “what they saw” before entering the host country, was not “what they got”. People (as embodiments of the cultural-cognitive institutions) would truly appear “strange” to such firms that go in as strangers quite unaware of the underlying tensions between the overt regulative and underlying cultural-cognitive institutions prevalent in a particular society or host country.

I lay out my arguments in more detail below on how the probability of unpleasant surprises arising out of institutional conflicts increases for MNE subsidiaries entering host countries with more non-representative versus representative governments.

In general, institutional change is incremental and path dependent and cultural-cognitive institutions change very slowly over time (North, 1991). Overt regulatory and economic institutions generally co-evolve with underlying cultural-cognitive institutions in a particular society, maintaining a congruence between these broad institution types. However, if the political system of a country is non-representative, the overt regulatory and economic institutions that it brings into existence will not necessarily reflect the cultural-cognitive institutions of the people who inhabit that country. Co-evolution and congruence between the different types of institutions is absent since a non-representative government can install overt regulative and economic institutions that do not broadly reflect the underlying “mental models” of the people. Thus, non-representative political systems are breeding grounds for the existence of conflicting regulatory/economic and cultural-cognitive institutions.

Secondly, non-representative governments, like all other governments, when they seek to attract foreign investment, need to project an image of the country in accordance with what is desired by the foreign companies. Toward this end, non-representative governments could deliberately change the overt regulative and economic institutions of the country, in a bid to appeal to the foreign firms. Their power to change the cultural-cognitive institutions within a limited time frame, however, remains very low, since changes in these are overwhelmingly path dependent and incremental, and therefore extremely difficult to establish in a short time span. Interesting examples would be countries such as China and Egypt, where the overt rules and regulations are brought into conformance with MNE expectations by the governments while cultural-cognitive institutions follow their own pattern of evolution rooted in the respective distinctive history and culture.

Finally, non-representative governments, like other governments, when they attempt to attract foreign investment, can resort to symbolic acts or impression management to make the country appear attractive to foreign firms. China and Egypt are again examples of countries whose governments clearly attempt to present an image of the country that would appeal to international firms that they seek to attract.

Non-representative governments typically exercise unrestrained power in the substantive acts that they can take with respect to the regulative and economic institutions, or symbolic acts that they can undertake with respect to the regulative, economic and/or cultural-cognitive institutions.

Thus, when non-representative governments seek to attract foreign investment, they do so in an environment where high institutional conflict already likely exists. These conflicts could become more acute through the government’s substantive acts. The surprise awaiting MNEs becomes
even larger due to symbolic acts that seek to make the country attractive for MNEs by projecting regulative and cultural-cognitive institutions in a favorable light which might be quite far from the reality.

To understand the ultimate effect of the existence of institutional conflicts in host countries, one would need to look at the survival rates of such firms. Considering the number of incoming firms, or the size of incoming FDI would be inadequate for the purpose of this study, as I am interested in examining the effects of a surprising scenario after the MNE has entered a host country and a subsidiary has been established. In the extreme cases, such unpleasantly surprising scenarios would lead to an early exit from the host country, thereby reducing the survival rate of subsidiaries in that host country. Thus:

Hypothesis

The survival rates of MNE subsidiaries in a host country would increase as the level of representative-ness of the host country’s government increases (i.e. the possible existence of “institutional conflicts” decreases).

Methodology

Sample and Measures

Data for this study were obtained from two main sources: the Toyo Keizai data publications of Japanese foreign subsidiaries, and the UNDP (United Nations Development Programme) “Human Development Report 2002.”

Organizational level data were compiled from three sources. Annual employment levels data was drawn from Kaisha Zaimu Karute, a publication of Toyo Keizai Inc. The sample firms’ principal industries were identified using Principal International Business: The World Marketing Directory and the Japan Company Handbook. The list of foreign subsidiaries of Japanese firms was drawn from Kaigai Shinshutsu Kigyou Souran (Japanese Overseas Investment). This is an annual compilation of the foreign investment activities of Japanese firms conducted by Toyo Keizai through annual mail and telephone surveys of major Japanese firms and supplemented by archival data where needed. These data were matched across various editions of this publication from 1986 through 2001 and were also matched with the Analyst’s Guide. This process resulted in a base sample size of over 30,000 subsidiaries of over 5,000 parent firms operating in over 100 countries. This database therefore lends itself exceptionally well to varied and robust cross-sectional and longitudinal analysis for studies such as the present one.

I restricted the sample to those subsidiaries that were founded in 1992 or in subsequent years through 2001. This ten year window was chosen for several reasons. As pointed out by earlier researchers (Delios and Beamish, 2001), restricting the sample in this way maximizes the likelihood that exiting subsidiaries were failed subsidiaries. As suggested by Delios and Beamish (2001), a ten year cut-off is appropriate for Japanese firms as Japanese managers have reported that their full investments unfold over a period of 10-15 years. Further, while a longer time frame would have provided more data, it would also have introduced inconsistencies in terms of the changing nature of political systems in some countries. A preliminary investigation reveals that the “Representative-ness” scores provided by the UNDP report for 2000 would hold true for most countries considered in this analysis for the chosen ten year period. Thus, considering the ten year period 1992-2001 reduced the sample to 10,355 subsidiary cases. Accounting further for missing
data, a final sample of 7884 subsidiaries of with 1398 exits was available. This is one of the largest samples ever used for a longitudinal study (pooled across ten years) to examine the effects of organizational and country level factors on MNE subsidiary performance (studied here as survival rates).

The UNDP report is subtitled “Deepening Democracy in a Fragmented World”, an allusion to the fact that it considers aspects of the political systems of countries for the first time in addition to economic and developmental ones. As it states clearly in the foreword: “this Human Development Report is first and foremost about the idea that politics is as important for human development as is economics”. The current study is undoubtedly one of the first to use the detailed political measures developed in this UNDP report in the context of international business and MNE subsidiary performance.

**Independent Variable**

**Representative-ness of governments:** The UNDP report provides a number of parameters for evaluating the representative-ness of national governments. One of these, “Polity”, provides an overall measure of the political systems’ representative-ness and was chosen for this study. The “Polity” measure is itself composed of a variety of indicators decided upon by in-house UNDP experts. It comprises of measures such as Competitiveness of Chief Executive Recruitment, Regulation of Participation, Competitiveness of Participation, etc. Countries are finally ranked from -10 (indicating very low representative-ness) to +10 (indicating very high representative-ness). Countries in the Toyo Keizai database were coded in this manner for the “Representative-ness” measure taking the scores from the UNDP report. A few countries that appeared in the Toyo Keizai database did not have “Representative-ness” values in the UNDP report and had to be dropped from the analysis. Prominent examples included semi-autonomous locations such as Hong Kong and Taiwan.

**Country level controls**

**GDP per capita:** Economic factors that would possibly have an effect on the subsidiary survival rate were introduced as controls. The GDP per capita values capture the current potential of the market in terms of the buying power of the consumers. It is likely that firms would prefer economies with higher values of GDP per capita and would therefore persist with subsidiaries founded in such markets. The GDP per capita values (in US $ adjusted for purchasing power parity) were taken from the Economist Intelligence Unit (EIU) and averaged for the ten year period under study 1992-2001. These values were then logarithmically transformed.

**GDP per capita annual growth rate:** These values were obtained from the EIU database which reports these as real GDP growth per capita (in percentages per annum) and averaged over the ten year period 1992-2001. The annual growth in GDP reflects the market potential of a country and high growth rates of an economy could be an important reason for a firm persisting with a subsidiary in a host country.

**Cultural distance:** This was calculated for Japan and each of the host countries in the sample based on Kogut and Singh’s (1988) measure. It is based upon Hofstede’s work (1980) and is created by summation of standardized differences between the four cultural dimensions. Earlier studies looking at non-economic host country indicators have considered culture as important. The key argument in this paper is that variance between different institutions in a particular country is important in addition to the variance within the same broad institution type (say
culture) across countries. Cultural distance is thus an important control to allow us to see whether the independent variable explain something new.

**Organization level controls**

Following standard practices from previous research (Delios and Beamish, 2001), I controlled for *subsidiary size* by taking the logarithmic transformation of the number of employees (last year of observation). Fixed effects were included for the *mode of entry* of the subsidiary, coded for four standard modes (Wholly Owned Subsidiary, Joint Venture, Acquisition, and Capital Participation), and for the two-digit *industry classification* based on Standard Industrial Classification (SIC) codes.

*Host country experience*: I introduce the experience of the parent firm in a host country (prior to setting up a particular subsidiary) as a control variable. For this measure, first all subsidiaries formed by a parent firm in the original sample of 30,013 cases were identified. For each subsidiary, the difference between its founding date and the last date of observation was calculated. These differences were then summed to arrive at the experience of a parent firm in a host country prior to founding a particular subsidiary. This value was then dummy coded as 1 for those parent firms with some host country experience and 0 as no host country experience.

**Analysis and Results**

I performed a survival analysis using the above independent and control variables on the sample in the ten year time frame 1992-2001 using Cox Regression. The descriptive statistics are presented in Table 1 and the survival analysis results are presented in Table 2.

My hypothesis predicts a positive relationship between representative-ness and subsidiary survival. This relationship is found to be significant (p<.05) and the direction of the slope supports the hypothesis (in the current model, exit is coded as 1). Higher values of representative-ness are found to be associated with lower likelihood of subsidiary exit or higher likelihood of subsidiary survival.

The broad theoretical arguments made in this paper are found to be valid, and the results are interesting. Cultural distance has received much attention in the literature and as such firms do take it into account to some extent while making their location decisions. My argument, that it is not only the variance *within* separate institution types, but rather the obscured variance *between* them that is important in making host country location decisions, is supported by the present empirical analysis (cultural distance was introduced into the model as a control variable).
### Table 1

Correlations, Means, and Standard Deviations

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>s.d.</th>
<th>1</th>
<th>2</th>
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<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
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</thead>
<tbody>
<tr>
<td><strong>Organizational Characteristics</strong></td>
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<td></td>
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<tr>
<td>1. Subsidiary size</td>
<td>3.67</td>
<td>1.75</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2. Host country experience b</td>
<td>.505</td>
<td>.500</td>
<td>.034</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>3. Mode of entry c</td>
<td>1.720</td>
<td>.733</td>
<td>.224</td>
<td>.022</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Country Characteristics</strong></td>
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<td></td>
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<tr>
<td>4. Representativeness</td>
<td>3.120</td>
<td>7.543</td>
<td>-.257</td>
<td>.018</td>
<td>-.070</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. GDP per capita d</td>
<td>8.957</td>
<td>.976</td>
<td>-.395</td>
<td>.123</td>
<td>-.150</td>
<td>.663</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. GDP growth rate</td>
<td>4.400</td>
<td>3.038</td>
<td>.280</td>
<td>.014</td>
<td>.100</td>
<td>-.907</td>
<td>-.654</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Cultural distance</td>
<td>2.901</td>
<td>.920</td>
<td>-.024</td>
<td>-.009</td>
<td>-.010</td>
<td>-.277</td>
<td>-.059</td>
<td>.131</td>
<td></td>
</tr>
<tr>
<td>8. Survival dummy e</td>
<td>.180</td>
<td>.382</td>
<td>-.082</td>
<td>.102</td>
<td>.064</td>
<td>.055</td>
<td>.101</td>
<td>-.060</td>
<td>-.011</td>
</tr>
</tbody>
</table>

*a Correlations greater than .05 or less than -.05 are significant at the .05 level

*b Parent’s experience in a host country prior to foundation of subsidiary = 1, no experience = 0

*c Categorical variable (Wholly Owned Subsidiary = 1, Joint Venture = 2, Acquisition = 3, Capital Participation = 4)

*d Logarithmic transformation

*e Subsidiary exit =1

Among the other control variables, several are found to be significant at various p-levels as indicated in Table 2. The “entry mode” of MNEs is an important consideration in international business research dealing with subsidiary formation in host countries. The current results support earlier studies on the importance of distinguishing between entry modes. The results here suggest that entry mode decisions could be important in the context of host country institutional conflicts and should be investigated further. Subsidiary size is found to be significant as well (p<.01) suggesting that investments made in a larger subsidiary either enable the subsidiary to deal better with the host country environment or simply increase survival rate due to escalation of commitment. Host country experience, which was introduced as a control in this model is found to be significant and needs to be examined by future research. As expected, country level economic factors (GDP per capita and GDP growth rate per capita) are also found to be
significant, suggesting their importance as controls in assessing the effects of non-economic variables on subsidiary performance.

Table 2

Subsidiary Survival $^a$

<table>
<thead>
<tr>
<th>Variable</th>
<th>Survival Analysis $^b$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Organizational Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td>1. Subsidiary size $^c$</td>
<td>-.147 (.020)***</td>
</tr>
<tr>
<td>2. Host country experience $^d$</td>
<td>.472 (.057)***</td>
</tr>
<tr>
<td>3. Mode of entry (Wholly Owned Subsidiary)</td>
<td></td>
</tr>
<tr>
<td>Joint Venture</td>
<td>-.594 (.126)***</td>
</tr>
<tr>
<td>Acquisition</td>
<td>-.185 (.123)</td>
</tr>
<tr>
<td>Capital Participation</td>
<td>.054 (.165)</td>
</tr>
<tr>
<td><strong>Country Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td>4. Representative-ness</td>
<td>-.021 (.010)**</td>
</tr>
<tr>
<td>5. GDP per capita $^e$</td>
<td>.197 (.044)***</td>
</tr>
<tr>
<td>6. GDP growth rate</td>
<td>-.047 (.023)*</td>
</tr>
<tr>
<td>7. Cultural distance</td>
<td>-.080 (.032)**</td>
</tr>
<tr>
<td><strong>Log-likelihood</strong></td>
<td>-11,685.46</td>
</tr>
<tr>
<td><strong>Model chi-square</strong></td>
<td>521.64***</td>
</tr>
<tr>
<td><strong>Number of cases</strong></td>
<td>7884</td>
</tr>
<tr>
<td><strong>Number of exits</strong></td>
<td>1398</td>
</tr>
</tbody>
</table>

$^a$ Cell entries are unstandardized coefficient estimates. Numbers in parentheses are standard errors. Fixed effects for two-digit Standard Industrial Classification codes for subsidiary industry were included but are not reported.

$^b$ In this model, exit = 1

$^c$ Logarithmic transformation

$^d$ Parent’s experience in a host country prior to foundation of subsidiary = 1, no experience = 0

* p<.10
** p<.05
*** p<.01
Discussion

Institutional conflict exists between institutions operating at various levels (region, society, country) and between various types of institutions (regulative, normative, cultural-cognitive). This study has focused on one aspect of this institutional conflict: the surprise by which it can catch firms that establish subsidiaries in countries prone to such conflicts.

Among various other issues that firms need to consider before establishing a subsidiary in a particular country is therefore the possible existence of such ‘institutional conflicts’. I have argued theoretically why such conflicts would exist and persist in countries with low representative-ness in political systems and thereby be a source of unpleasant surprises to firms investing in such locations.

As the UNDP Report (2002) states, the ideal of democracy remains far from being achieved in a majority of countries across the world. The problem is thus large and has important practical implications. From a managerial implication perspective, the choices made in terms of investing in non-democratic countries must therefore be fully studied and potential institutional conflicts taken into account. A realization of the existence and importance of such conflicts is the first step towards lowering the element of surprise that accompanies their discovery. This paper is a first step in doing just that.

While contributing to international business research in the area of MNEs and institutional environments, this paper also opens up the area of empirical studies of institutional conflicts from a general institution-organization interaction perspective. Studies of institutions have much to gain in terms of increased granularity by considering the parsing of institutions into different ‘types’ (say formal regulative vis-à-vis informal cultural institutions) and ‘levels’ (e.g. institutions at the level of a local community vis-à-vis at the country level) and looking at organization-institution interplay in light of potential interactions between different elements of the overall institutional environment.

Limitations and Future Research

While I have used representative-ness of the host country’s government as an indicator of the existence or absence of institutional conflicts, other finer grained measures could be developed to test for the core theoretical arguments related to institutional conflict set forth in this paper. For example, separate measures developed for “overt regulative institutions” and “underlying cultural institutions” could assign a score on each of these indicators to various countries. These could then be utilized for directly exploring the notion of institutional conflicts at the level of countries.

This study introduced the prior experience of the parent firm in a host country as a control variable. However, the effects of experience need to be examined in more detail. In particular, the interaction effects of experience with representative-ness could be interesting to look at. With respect to subsidiary experience in a particular host country, it is also conceivable that subsidiaries that survive beyond a threshold in terms of number of years spent in a particular host country would develop the ability to deal with the underlying institutional conflict even if the parent firm had no prior experience in that particular host country. Future research could unravel these aspects of the experience-survival linkage.

For the analysis here, the consideration of parent firm experience is discussed as relevant only if it is with respect to the host country under consideration. It is however also conceivable that parent firms that have encountered institutional conflicts in one location might be careful about
them while approaching another. Further studies could explore if the learning from one host country environment where institutional conflicts are present translates into improved survival in other host countries with similar institutional conflicts.

The sample of countries and subsidiaries could also be enlarged if the period of study is increased from the current 1992-2001 period to one going much further back. For studies involving longer periods of time, detailed knowledge of each country’s changing political systems would be necessary. If a particular country sees major changes in its “Representative-ness” index during the time period under study, it would have to be excluded from the analysis to avoid inconsistency in the results. As an alternative, countries that have had changes in their “Representative-ness” scores could be studied separately, with the analysis focused on a comparison based on the time frame before and after such a change.

Finally, another very interesting setting for studying institutional conflict would be “post-colonial countries”. Many countries across the world have “imported” overt regulative and economic institutions from their former colonial parents, while their cultural-cognitive institutions are evolving at a much slower pace. The lag in the respective changes of these different types of institutions could create conditions for institutional conflict that would be interesting to explore in a parallel study.

References


