CHAPTER 10

UNBUNDLING THE INSTITUTION-BASED VIEW OF INTERNATIONAL BUSINESS STRATEGY

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10.1 Introduction

What drives firm strategy in international business (IB)? Decades of IB research have long suggested that institutions—commonly known as the 'rules of the game' (North 1990) around the world—are a major driver behind IB strategy. Consolidating earlier work on environments and cultures (viewed as part of informal institutions),

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recent work has articulated the emergence of an institution-based view of IB strategy (Meyer and Peng 2005; Peng 2002, 2003; Peng, Wang, and Jiang 2008). This view has been argued to be one of the three leading perspectives in IB strategy—the other two leading perspectives are industry- and resource-based views (Peng 2006).

The understanding that 'institutions matter' is now hardly novel or controversial. The next challenge is to specify how institutions matter, under what circumstances, to what extent, and in what ways. Critics suggest that the industry-based view has the Porter (1980) five forces framework and the resource-based view converges on the Barney (1991) VRIO framework,[1] yet what *specific* propositions or frameworks does the institution-based view of IB strategy have? This chapter addresses this important and legitimate question, by identifying and articulating the two core propositions underpinning the institution-based view: (1) individuals and firms act rationally according to formal and informal institutional structures; (2) when formal institutions fail, informal institutions regulate exchange relationships. In other words, this chapter endeavours to advance the institution-based view of IB strategy by *unbundling* the broad proposition that 'institutions matter'. We leverage and extend contemporary research to illustrate the explanatory and predictive power of the two propositions underpinning the institution-based view of IB strategy.

10.2 An Institution-Based View of IB Strategy

North (1990: 3) defines institutions as 'the humanly devised constraints that structure human interaction', while Scott (1995: 33) defines institutions as 'regulative, normative, and cognitive structures and activities that provide stability and meaning to social behavior'. Overall, institutions operate as formal and informal structures for social and economic exchanges.

North's metaphor on institutions as being the 'ules of the game' (1990) has influenced the character of IB strategy research over the recent decade (Peng and Heath 1996; Wright et al. 2005). This important concept has expanded the scope of IB strategy research to account for aspects related to dimensions of national context, culture, government, transactions, and social interactions. This work has underscored the significance of institutions in determining how economic and social exchanges unfold as functions of formal and informal institutional frameworks. From a formal perspective, IB strategy research has leveraged institutional insights in international contexts to look at a diverse range of topics, such as entry decisions (Delios and Henisz 2003), reactions to legal systems (La Porta et al. 2004), foreign direct investment strategies (Chung and Beamish 2005; Globerman and Shapiro 2003), diversification decisions (Peng and Delios 2006; Peng, Lee, and Wang 2005), piracy (Hill 2007), corruption (Lee and Oh 2007), and venture capital (Ahlstrom, Bruton, and Yeh 2007).

In advocating the institution-based view, we also underscore the importance of bringing institutions more into the foreground of IB strategy research, as opposed to keeping them in the background. This view differentiates from the legacy depiction in strategy of the environment expressed in terms of market dynamics (Dess and Beard 1984; Lawrence and Lorsch 1969). Adopting the institution-based view as a central perspective—as opposed to 'controlling for institutions' (within the background)—has been emphasized more recently within IB research (Narayanan and Fahey 2005; Peng, Weng, and Jiang 2008; Teegen, Doh, and Vachari 2004). In the next two sections, we build on the momentum, by proposing (1) how institutions shape individual and firm behaviour, and (2) how informal institutions act as compensatory structures for formal institutional to help regulate exchange relationships.

10.3 Institutions as Defining Structures in IB Strategy

The impact of institutions on IB strategy is pervasive and serves many functions. Institutions are pervasive in that they are capable of shaping the behaviors of multiple actors (i.e. individuals, firms, industries, and non-governmental organizations (NGOs)). More broadly speaking, institutions serve to reduce uncertainty for different actors by conditioning the ruling norms of firm behaviours and defining the boundaries of what is considered legitimate. Actors, in turn, rationally pursue their interests and make choices within the formal and informal constraints in a given institutional framework.

Uncertainty clouds the judgment of actors, and the cues that inform decisions and actions emerge from the relevant institutions. Institutions can provide a rationale that justifies compliance with a norm. Referring to Scott's (1995: 35) three pillars, compliance occurs through '(1) expedience (regulative pillar), (2) social obligation (normative pillar), or (3) on a taken for granted basis (cognitive pillar)'.

For example, political systems can pose uncertainty in terms of how transactions can be influenced by governments and the institutional structure governments provide (Acemoglu and Johnson 2005). Predominant logic of political systems states that more democratically oriented political systems provide more certainty and predictability within society (Olsen 1993). Thus, political systems can define the institutional environment through the degree of political risk that the political system imposes (Butler and Joaquin 1998; Kobrin 1982; Nigh 1985). Applying this logic to decisions involving strategic investment, we discuss how political systems carry great meaning to the foreign perception of political risk, and how property rights transactions are selectively impeded by the state of political-legal institutions (Williamson 1991).

To illustrate the extremity to which the political system may pervade international strategic decisions, consider the case of Argentina's oil industry between the 1950s and the 1970s. In this situation, changes in ruling party lead to an unpredictable level of government involvement within this industry. The pendulum-like political changes introduced political risk to foreign firms operating within this industry. Argentina's government in 1955 cancelled international contracts signed by a previous president, Peron, in 1952. The next president signed new contracts in 1958, which were nullified in 1963 by a different president. Foreign oil companies were invited to return in 1966, expelled in 1973, and again encouraged to enter after 1976 (Guillen 2001: 135). It is hardly surprising that foreign oil companies are sick and tired, and would rather go to 'greener pastures' elsewhere. Not only are these decisions rational, but given an uncertain institutional framework, such decisions may explain why so many internationalization manœuvres remain confined to regions that offer more consistent predictability (Collinson and Rugman 2007; Rugman and Verbeke 2004).

The representation of political systems within the institutional environment is operationalized in simple terms of relative polity between nations, endogenous political risk, or transparency. The former aspects mentioned are most closely identified according to the regulative pillar, which accounts for the efficiency or the bureaucratic influence on transactions. The latter is addressed by the cognitive pillar, in that formal institutions exist, yet informal institutions guide behaviours. Thus, the resultant templates of legitimacy are a product of the formal institutions and edicts from the government and the informal (or realistic) institutions that account for the 'institutional reality'. If the government is transparent as a trustworthy agent of its prescribed rules and ideologies, then there should be stronger correspondence between the intended institutional structure and that which is observed by the society. If the reality observed by domestic and foreign multinational firms differs, then there may be evidence of informal institutions as contributing to the accepted norms (Peng 2003; Peng and Heath 1996). Thus, we see observance of political dimensions prescribing norms and affecting uncertainty in the environment in different ways (Acemoglu and Johnson 2005).

Consider recent longitudinal research on patenting in Latin American and Caribbean countries. Khoury and Cuervo-Cazurra (2007) investigate how the institutional adoption of stricter laws on patenting affects the rational judgments of domestic and foreign inventors. Their findings reveal that more autocratic political systems that adopt stricter patent laws, by and large, realize more patenting activity as a whole, which indicates a strong dependency on institutions as a guide for strategic pursuits. However, they also find that while foreign inventors draw on coexisting cues from polity and current patent laws, domestic inventors only draw on the condition of the legal system as the cue for pursuing property rights through patenting.

Beyond the message of how institutions affect rational decisions, Khoury and Cuervo-Cazurra (2007) and Khoury and Peng (2007) highlight *how* various institutions matter differently to the rational decisions of different actors. In each case, there are unique interpretations of the rules of the game in the same environment, yet the information used to assemble interpretations is based on specific assumptions and understandings of how and when formal and informal institutions prevail. In this case, the same interests were at stake from an international perspective—intellectual property rights, yet the institutional cues that were taken provided a rational direction for strategic pursuit. Taken in sum, individuals and firms directly draw on inputs from the institutional environment in order to inform their strategic decisions. Thus:

Proposition 1: Managers and firms rationally pursue their interests and make choices within the formal and informal constraints in a given institutional framework

Consider another example—counterfeiting. Close to 10 per cent of all world trade is reportedly in counterfeits. Clearly, hundreds of firms and thousands of individuals are involved. None of these individuals, when graduating from high school and filling out a form in terms of what career they would pursue in the future, would fill out that they would want to join the illegal world of counterfeiting. Most students would naturally say that they would want to be managers, doctors, teachers, and professors when they grew up. Assuming there is no presence of slavery or forced labour, then what happened to thousands of individuals who *voluntarily* chose to engage in counterfeiting?

Our Proposition 1 offers a clue: The key to understanding this phenomenon is realizing that these individuals are not amoral monsters, but just ordinary people. They have made a *rational* decision (from their standpoint at least), given an institutional framework of weak intellectual property (IP) protection and availability of certain manufacturing and distribution capabilities (Peng 2006: 117; see also Gillespie 2003). Therefore, a most effective weapon to combat counterfeiting—or to initiate strategic changes among individuals and firms involved in counterfeiting—is to enhance IP protection by changing the pay-off structure of counterfeiters (Grossman 2005). For example, counterfeiters in China will be criminally prosecuted only if their profits exceed approximately $10,000. But few of them are dumb enough to keep such records. Counterfeiters, if they are caught, can routinely get away with a $1,000 fine, which is usually regarded as a (small) cost of doing business—this logic is quite rational. As online music piracy becomes more widespread, the cost of suing an alleged music pirate in China is now $13,000. However, convicted pirates only need to pay $130 per case (*Business Week* 2007). Again, there is hardly any deterrence. In the United States, convicted counterfeiters face fines of up to $2 million and ten years in prison for a *first* offence. The penalty for illegal music piracy can be as stiff as $150,000 *per song* downloaded (*Business Week* 2003). Not surprisingly, China has a more rampant counterfeiting and music piracy problem than the United States. The hope is that IP reforms to criminalize all counterfeiting activities regardless of the amount of profits, such as those currently being discussed in China (Bird 2006), may significantly reduce counterfeiters' incentive (Peng 2006: 137–8).

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10.4 Formal and Informal Institutions As Compensatory Structures

The strategies used by firms can reflect the translation of formal and informal constraints within a nation's institutional framework. Formal and informal institutions originate from different sources within the firm's institutional environment, yet they can fulfill similar voids in guiding firm behavior. Specifically, when formal constraints are absent or incomplete, informal constraints intervene to mitigate uncertainty and provide a guide to managers. In general:

Proposition 2: While formal and informal institutions combine to govern firm behaviour, in situations where formal constraints are unclear or fail, informal constraints will play a larger role in reducing uncertainty and providing constancy to managers and firms

Institutions that are depicted as informal can exist as societal activities, cultures, and ethics that are supported by normative and cognitive pillars. Strategic behaviour can be affected by the normative pillar to the extent that strategies relate to such informal institutions as societal norms (Peng, Weng, and Jiang 2008). Strategic behaviour can also be influenced by the cognitive pillar to the extent that informal institutions, such as taken-for-granted values and shared beliefs can be internalized into firm-level decisions (Mathews 2006).

The overall balance between formal and informal may vary across nations and over time. Thus, as a whole, firms that share institutional environments with one another may collectively draw from similar types of institutions to inform the similar types of decisions. For instance, culture, as an informal institution (Hofstede et al. 2002: 800; Redding 2005: 123—see also Hofstede 2007), may inform strategic decisions in the absence of formal institutions (Peng, Weng, and Jiang 2008; Singh 2007).

For example, in the wake of political collapse in the former Soviet Union, Russian entrepreneurs attempted to launch and survive through the reliance on social ties and connections (known as *blat*) within their local networks (Puffer and McCarthy 2003). This informal institution of using social ties to facilitate economic exchanges is embedded in the culture and provides a reasonable means to realize continuity for firms weathering a formal change in political-economic institutions (Peng and Heath 1996). Others have also documented this phenomenon in Russia (Guriev and Rachinsky 2005). Similar occurrences have been shown in other national settings, such as in Chile (Khanna and Palepu 2000), the Czech Republic (Newman 2000), Hungary (Stark 1996), India (Kedia, Mukerjee, and Lahiri 2006), Poland (Spicer, McDermott, and Kogut 2000), and South Korea (Chang and Hong 2000; Lee, Peng, and Lee 2008) during these countries' institutional transitions. The common condition in these comparatively unique environments is the convergence towards informal institutions in lieu of deficient or absent formal institutions. Specifically, there is a predominant reliance on network-based strategies that are acceptable via the existing cultural norms (Peng 2003). In other words, individuals and firms 'often find ways of altering the terms of their formal and informal contracts to avoid the adverse effects of weak [formal] contracting institutions' (Acemoglu and Johnson 2005: 949).

Similarly, firms sharing the same institutional environment may draw from the same types of institutions. However, the unique mixture of formal and informal institutional guides may vary. To elaborate on this point, a firm can be considered as a bounded group of individuals with a common purpose, and its structure reflects the collective translation of institutions by the individuals that run the firm (North, Wallis, and Weingast 2006). Although all firms share a common need to coordinate their decisions and routines, firms are heterogeneous in comparison to one another. There are many different aspects of heterogeneity between firms that can exist, and one such aspect is the unique understanding of shared institutions in the environment.

For instance, formal institutions, like national laws that are intended to enforce safe work conditions in employee work environments, may be more uniformly understood within a shared institutional environment, yet the minimum quality standards that are adhered may be variably implemented amongst a cross-section of firms. In such a case, beyond a core, basic understanding of rules, there exists a collectively shared belief system at some level. For instance, there exists a relative understanding of the tolerable safety conditions in a work environment that are necessary in order for a firm to persist. Thus, informal institutions, in this case, may compensate at varying degrees for what is perpetuated by formal institutions. This relationship enables institutional structures to compensate for one another.

10.5 Discussion

10.5.1 Recent Interest

This chapter has contributed to the literature on the institution-based view of IB strategy, by unbundling this view beyond the usual 'institutions matter' proposition. The idea that 'institutions matter' is probably 'as old as the study of economics,' dating back to Adam Smith who recognized that the state must define property rights and enforce contracts (McMillan 2007). So why is there a strong emerging interest in this view recently? The answer stems from (1) the legacy rendering of institutions as 'background' (or environment) in much of IB strategy research and (2) the recent realization 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' (Ingram and Silverman 2002: 20).

This realization is especially strong as IB strategy researchers now increasingly deal with competition in emerging economies, which are governed by a set of formal and informal institutional frameworks quite different from those in developed economies (see Peng, Weng, and Jiang 2008 for elaboration). When markets function smoothly in developed economies, the market-supporting institutions (in the background) 'are almost invisible', according to McMillan (2007), who goes on to argue that when markets work poorly in emerging economies, 'the absence of institutions is conspicuous'.

Our two propositions advance the institution-based view of IB strategy, by identifying and articulating the core explanations and predictions underpinning this view. These propositions are not only relevant to IB strategy in emerging economies, but also in developed economies. In summary, this chapter can be positioned as part of the recent stream to leverage, extend, and deepen the understanding of the institution-based view of IB strategy.

10.5.2 Why the 'Institution-Based' View Label?

One interesting point to discuss is why we use the particular label an '*institution-based* view'? Is it the same as an 'institutional view'? Is it the same as 'institutional economics'? Or 'institutional theory'? What is the value of a new label 'institution-based view'?

The adoption of the term 'institution-based view', coined by Peng (2002), stems from (1) the confusion in the literature and (2) the decision to avoid interdisciplinary turf battle. First, there has been a broad intellectual movement in recent decades (largely based in the social sciences) that has centred on new institutionalism as a vibrant area of scholarly interest in all things considered 'institutional'. Although this may have led to more institution-based research pursuits, this has also prompted confusion. Broadly speaking, any concept that invokes a new institutionalism framing, *in our view*, can be legitimately labeled 'institutional theory'. However, the usual convention—or norm, if we will—in the literature is that the term 'institutional theory' is increasingly used to refer to the *sociological* version of the institutional literature, such as that represented by DiMaggio and Powell (1983) and Scott (1995). The economic version, represented by North (1990), is often simply labelled as 'institutional economics'. When our earlier work—Peng and Heath (1996), Peng (2003), and Peng, Lee, and Wang (2005)—was going through the review process, we were pushed by some economically oriented reviewers to declare that our theoretical background was North's (1990) 'institutional economics', which (according to these reviewers) should have nothing to do with (the sociological) 'institutional theory'. At the same time, we were pushed by some sociologically oriented reviewers to declare our 'party line' by following the sociological version of 'institutional theory' (as opposed to 'institutional economics').

Second, it is clear that this confusion in the literature not only reflects the usual scholarly disagreements, typical within any discipline, on how to most effectively label a body of literature,[2] but also embodies the interdisciplinary competition (or 'turf battle') between economically and sociologically oriented scholars for dominance in this increasingly important literature. Our work was indeed inspired by *both* the economic and sociological versions of the institutional literature. To remain intellectually honest, we felt uncomfortable declaring allegiance to any disciplinary 'party line' at the expense of another discipline. Scholarly, this would add more confusion, because Scott (1995) has long acknowledged the integration of North's (1990) ideas and some sociological work in this area. North's (2005) more recent work has explicitly discussed 'stickiness' (resistance to chance) as part of cognition, which notably bears reciprocal correspondence to Scott's (1995) third— cognitive— pillar. Therefore, in response to reviewer pressures from both sides, Peng (2003: 276) clarified:

> Although the economic (e.g., North 1990) and sociological (e.g., Scott 1995) versions of institutional theory have some differences, they are broadly complementary (Scott 1995). Following Peng and Heath (1996: 499), who suggest that 'a combination of the two is natural' for management research, here I draw on the best available insights from the institutional literature, regardless of the disciplinary background.
>
> (Peng 2003: 276)

Although this reconciliation appeared as a low-profile footnote, it reflected a conscientious decision to avoid an unprofitable interdisciplinary turf battle and an opportunity to advance IB strategy research in this direction. In retrospect, reviewer pressures from both sides were a blessing, because they made it impossible to use labels such as 'institutional economics' or 'institutional theory' in a scholarly impartial way. Innovation is often forced by necessity. In this case, the necessity to disagree with reviewers while still getting the papers published and cross-fertilization with other perspectives, especially the resource-based view,[3] eventually led to the identification of the new label, 'institution-based view', that best captures the essence of this new perspective in IB strategy research (Peng 2002). Fortunately, reviewers from both sides eventually found this label acceptable.

The value of the new label, institution-based view, is that this is a progeny that the IB strategy field can lay claim to as its own. While it clearly integrates 'institutional economics' and 'institutional theory', it is fundamentally driven by an interest in the key question for the IB field, 'What determines the international success and failure of firms around the world?' (Peng 2004). As our discipline gradually matures, we need to have the self-confidence (see Meyer 2006) to declare that we are doing neither second-class economics nor second-class sociology. Instead, we are doing first-class IB strategy research. The new label helps us differentiate from existing work in economics and sociology. Within IB strategy, the institution-based view has been advocated by Peng (2006) to be one of the three leading perspectives that, together with two other incumbent perspectives (namely, industry- and resource-based views), form a 'strategy tripod' (see Peng (2009) for more recent elaboration).

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10.6 Conclusion

While it has long been known that the rules of the game that specify the relative payoffs play a key role in determining individual and firm behaviour, we have just set out on the long road to achieving an understanding of how institutions affect IB strategy around the world. Positioned to complement earlier work that does not clearly spell out the two core propositions, this chapter has made some progress in pushing forward the institution-based view of IB strategy. In conclusion, if this chapter can contain one message, we would like it to be a sense of urgency for scholars around the world to specify, test, support, falsify, and/or challenge these two institution-based propositions for IB strategy—both theoretically and empirically.

Notes

1. VRIO refers to value, rarity, imitability, and organization (see Barney 1991 and Peng 2006).
2. For example, consider the debate on what is a resource versus what is a capability in the strategy literature.
3. Mike Peng wishes to acknowledge the intellectual and personal influence of Jay Barney. At that time, Peng was Barney's colleague at Ohio State. Invited by Barney, Peng (2001) contributed an article to the *Journal of Management* special issue that commemorated the 10th anniversary of Barney (1991). Peng and Barney also collaborated on joint work which was published as Lee, Peng, and Barney (2007).

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