An Alternative Explanation for Internationalization of Firms in Emerging Economies:

The Indirect Incentive Through Domestic Legitimacy, Status and Reputation

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Abstract

In traditional theories, firms gained internationalization benefits directly from foreign markets and this became a foremost incentive for any firm to venture beyond local markets. This pure direct effect has been challenged in emerging economies where some institutional factors create incentives for internationalization, encouraging firms to go abroad by offering some domestic gains, for instance, legitimacy, status and reputation, which help the firms´ domestic business. By doing so, firms benefit indirectly from domestic business. Addressing the research gap of this indirect effect, this paper contributes to extant literature relating to internationalization. Based on data collected from China, I attempt to reveal the indirect incentive effect which exists through exploring internationalization upon domestic legitimacy, status and reputation.

Introduction

Why firms internationalize is one of the key topics in International Business (IB) studies. Starting from almost two hundred years ago (Ricardo, 1821), numerous scholars explored the possible incentives of internationalization from various perspectives. But as indicated in Figure 1 below, all those incentives came as a direct effect of a firm's internationalization - it is possible that some benefits exist beyond national boundary and firms pursue those gains directly through foreign market.

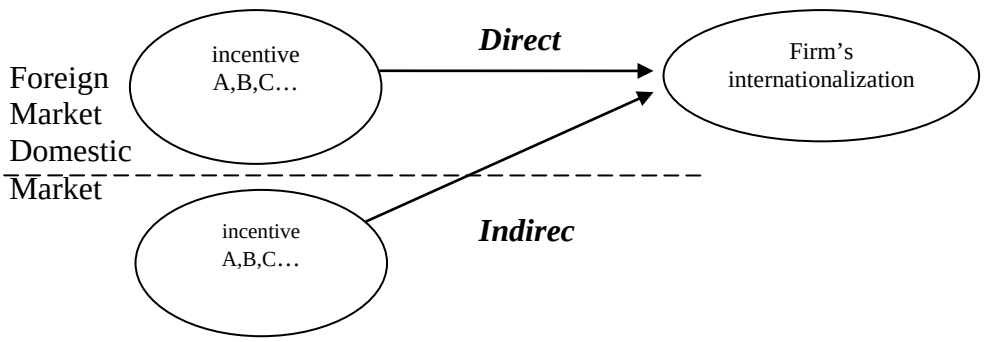

Figure 1 Theoretical model of direct/ indirect incentives of firm's internationalization

It is quite natural to think about the indirect effect: could there be some benefits within the home country which can motivate firms to internationalize? This indirect incentive effect is very much possible to occur in emerging economies. Not only because it has many unique characteristics compared with developed economies where the traditional IB theories emerged, but also because plenty and fresh elements are involved in their internationalization processes - the "be international" trend has started recently and is rapidly expanding in emerging economies (Mike et al., 2008). Consider a Chinese firm for instance - it is a medium sized manufacturing company with over 90% revenue from its local market. Despite its local concentration, this company keeps business with several foreign customers at a low profit level. The General Manager of this firm explains: "We don´t really care about our international business, which is not our primary source of profits … By having an international presence, we demonstrate professional to our domestic customers and attract more domestic business, especially when almost everyone in our industry in China is doing so. We will become marginalized if don´t follow the trend…."

Obviously, the incentives mentioned here by this general manager are beyond the "direct scope" of traditional IB theories and indicate internationalization as a process influenced by isomorphic pressure across firms to gain legitimacy (as opposed to efficiency), to attain social status and acquire reputational benefits in their home country. Unfortunately, although there are some comparison studies covering legitimacy, reputation and status in emerging economies (Chaharbaghi et al., 2003) and some draw upon institutional theory to consider the influence of institutional environment upon international business(Chan et al., 2008), none has yet investigated the indirect influence of all the three factors upon internationalization in emerging economies, and empirically tested and compared the magnitude of those effects. Therefore, I hope to fill the above mentioned research gaps by this study.

Discussion and hypothesis

Incentives of internationalization

A lot of studies have been done in IB with respect to the subject of internationalization over the past thirty years. There are many definitions and recent one of Welch & Luostarinen (1999) described internationalization as a complex and multidimensional process, by which firms increase their involvement in international business activities.

Generally, traditional IB theories consider the three dimensions as incentive: (1) resource management, (2) dealing with competitors, and (3) customer relationships. The existing debates mostly refer to their relative importance. First, internalization could increase firm efficiency that results from better management of interdependencies. Many studies contributed to this stream, the earliest was international trade theory for a relative productivity advantage, which found that firms increase efficiency by trading with more productive countries (Ricardo, 1821). Penrose (1959) suggested firms find new customers by using more profitable resources and Vernon (1966) thought internationalization could extend product life cycle across countries to enhance production scale. Even though transaction cost economics (TCE) (Hennart, 1982; Teece, 1982) and internalization theory (Buckley & Casson, 1976; Rugman, 1986) originated in the US and EU separately, they shared similar ideas that internationalization was a way to solve imperfections in international markets. Second, international organization (IO) based approaches highlight the oligopolistic motives behind internationalization and its effects upon strength of market power. Doing international business was aimed at seeking monopolist rent (Hymer, 1976) or as an oligopolistic reaction to competitors' activity (Aliber, 1970; Knickerbocker,1973). Firm's competitive advantages like brand name, managerial skills and technology were thought to be able to transfer into

foreign markets. Finally, internationalization may also have benefits for managing the relationship with customers, independently of firm efficiency and market power. Since internationalization exposed firms to more diversified customers, the learning of various skills including customer relationship management skills were supposed to improve (Bartlett & Ghoshal, 1989). Although the "eclectic OLI Model" developed by Dunning (1981) comprehensively inspected advantage based on transaction cost theory and specified three key factors as incentives: Ownership advantage, Location advantage, and International advantage It still remains the same as other classic theories and is not enough to explain the indirect incentive effect as we described earlier in the introduction part.

Emerging economies

Emerging economies differ from developed market economies and are not institutionally well developed. Thus alternative mechanisms other than market are very necessary and powerful to supervise domestic economic activities (Hoskisson et al., 2000).

Emerging economies normally encourage internationalization due to a variety of reasons. First, most emerging economies are less developed. Consequently, their citizens treat internationalization as an acknowledgement of the developed world and are proud of this phenomenon. Second, corporations in emerging economies are usually short of comprehensive, scientific and strict control system. Their customers are not confident with the national standard and prefer international standard, which they suppose is more rigorous. Thus, internationalization becomes a signal of good quality and is appreciated by customers. Third, governments of emerging economies are eager to bring foreign currencies to increase their participation in global economy, and international business is a common mean of accumulating foreign currencies. Furthermore, the production capacity and labour resources exceed domestic demand in many emerging economies. So the governments need foreign markets to absorb those extra capacities and keep the domestic economy stable. In addition, broadly participating in global economy helps build up an open, healthy and friendly image in front of the world. As a consequence, internationalization becomes a way to build reputation, legitimacy and centrality in internal markets, resulting in increased domestic performance. Three hypotheses are developed here.

H1a: *Higher firm´s internationalization positively impacts its domestic legitimacy.*
H1b: *Higher firm´s internationalization positively impacts its domestic status.*
H1c: *Higher firm´s internationalization positively impacts its domestic reputation.*

Firm legitimacy, status and reputation

The concept of legitimacy is very similar with status or reputation (Washington & Zajac., 2004). Legitimacy, however, is a generalized perception of whether an organization is acting appropriately follow societal norms – it can be explicit or implicit (Scott, 2001; Suchman, 1995). Social actors generally accept and take legitimated organizations for granted (Suchman, 1995). Enterprises that have certain level of legitimacy can more easily obtain access to resources and markets needed to prosper (Dowling & Pfeffer, 1975). Without the support and protection conferred by legitimacy, a firm's ability to run business can be seriously hindered by governments, banks, social groups or simply by market indifference (Tsang, 1996).

Status is the 'stock' that corresponds to different flows in the network of partners, it refers organization´s relative position to others (Podolny & Phillips, 1996). Normally, high status firm has lower transaction costs in acquiring resources. Status is a signal of quality in certain market conditions because higher status actors are expected to engage in higher quality

activities (Podolny, 1993). Mostly, status is positively associated with performance and high status organizations prefer partners with high status as well (Stuart et al., 1999).

Reputation is observer's collective judgments of a corporation based on assessments of the firm´s attributes over time. It could be a signal of future performance based on past performance (Fombrun & Shanley, 1990; Shane & Cable, 2002). Specifically, firms with superior past performances are more likely to invest for quality since reputation becomes a valuable asset to them, and the high reputation could lead to high performance (Diamond, 1989).

By the previous contributions in the concept building and theoretical development of the three concepts, the *positive impacts* from domestic legitimacy, status and reputation to domestic performance can be soundly assumed in the testing model in Figure 2.

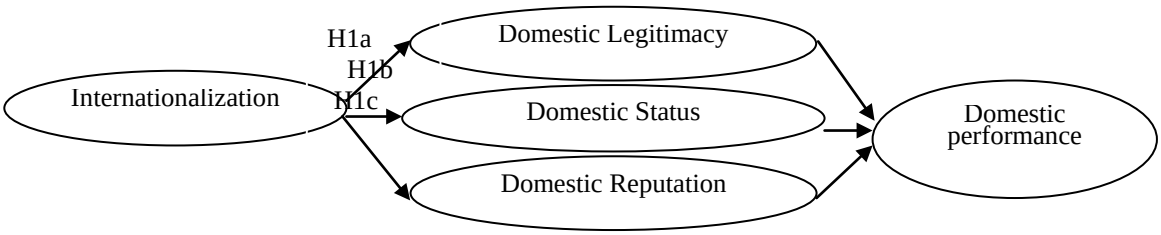

Figure 2 The theoretical model for hypothesis testing at corporate level

Procedures for collecting data

This paper will test the hypotheses by a sample group of public Chinese firms. All of these firms should have sufficient information of market performance in their "segment report" (by default which is geographic in nature), derived from annual report during 2001-2010. The duration 2001-2010 is chosen to correspond with the time interval of one legitimacy measurement – "China Top Brand". The total number of all publicly listed Chinese firms (including listings in mainland China stock exchange market, Hong Kong stock exchange market, and overseas stock exchange market, e.g. US, UK, Singapore) is around 1,600 as at April 2010. Since some firms do not provide necessary data in annual reports, the estimated final valid sample size is 200-250.

China is an appropriate country to test our hypotheses not only because it is the biggest emerging economy in the world but also firms here face strong institutional and competitive pressure making legitimacy, status and reputation important in the business (Scott & Meyer, 1991). Using sample from one country controls differences in institutional norms. The required data could be collected from the official website of related Stock Exchange market and sample firms. This study is designed to test relationships among firm´s internationalization at **t-1**year and the increase of firm´s domestic legitimacy/status/reputation at **t0** year and the corresponded increase magnitude of domestic performance of **t+1 and t+2** year´s average – as a longitudinal study, it takes time for effects to be observed.

Dependent Variable

Firm´s Legitimacy, status and reputation are complex concepts, and play the role as dependent & independent variable here.

Firm´s legitimacy Following Fombrun (1996) and Ruef & Scott (1998), the research design is limited to certain dimensions: *regulative legitimacy* and *normative legitimacy*. *Regulative legitimacy* is measured by the official certificate "China Top Brand", a typical regulative legitimacy to the firm awarded by 'General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China', a governmental department. As soon as the firm gets certified, the brand owner firm will have official protection and support from government, state banks, etc. The logo of "China Top Brand" is allowed to put on the packing, the product or be mentioned in advertisement. This certificate is granted since 2001. Currently there are 1949 certified brands. Most of the times, one firm can only have one "China Top Brand" product, but some big firms may have more. For example, Lenovo has four such products. There are around 1500 legitimate firms qualifying to above norms. The variable *regulatory legitimacy is* designed by numbering the categories 0, 1 with firm having or not having this certificate in the studied sample group. The measure of *normative legitimacy* is based on professional endorsements (Ruef & Scott, 1998) - the accreditation of firms from non-official associations and memberships, and each accreditation is operationalized as a categorical variable.

Firm´s Status Firm's status is measured by Bonacich's (1987) power centrality, which is consistent with recent studies on market network positions (Podolny, 2001). According to this measure, the status of a firm is dependent on the number and status of other firms participating in its equity alliance. The necessary financing information can be found in the annual report of listed companies. In order to produce an unbiased measure of status, this study plans to examine the pattern of investment not only among the firms in sample group, but also among all Chinese firms over the period of the study. Each of the Bonacich's power centrality score will be calculated for each firm involved in this research network, and after standardizing, the status of a firm will be directly proportional to its score.

Firm´s reputation This study plans to capture reputation, as a reflection of past performance by evidence of past manufacturing activity and media visibility (Roberts & Dowling, 2002). Such manufacturing activity is designed to be measured by three items: the total number of products, the total volume of production and the total amount of revenue. This study will measure media visibility by the number of times the firm had been mentioned in "Economic Observer" (the most popular financial newspaper in China) over the period of the study (2001-2010). Thus, the overall measure of reputation is a composite variable consisting of past manufacturing activity and visibility.

Firm´s domestic performance This study will measure firm domestic performance by the profitability and revenue growth of its domestic business. Such information is included in the segment report of annual report of sample firms.

Independent variable

Firm´s internationalization This study measures firm´s internationalization by the ratio of revenue proportion of international business of sample firm to average of revenue proportion of international business of all Chinese firms. The number of molecular part is found in segment part of public annual report of sample firms; the number of denominator part is found in *National Standard announced by National Bureau of Statics of China* and *Ministry of Commerce of the People's Republic of China*.

Control Variable

Some theories suggest that age and size can be positively related to legitimacy and reputation (Aldrich & Auster, 1986; Baldi, 1997). Therefore, I include them as control variables. Older organizations have established roles and a history of successful accomplishments. Hence they are more deeply embedded in networks of economic and social relationships. The age of the firm will be measured by the introduction of firm´s website. Larger organizations usually have more contractual and social ties with stakeholders, which increases their visibility, status, and legitimacy (Fombrun & Shanley, 1990; Phillips & Zuckerman, 2001). Firm size will be measured using total average assets, number of employees, and market share, with data from annual report.

The yearly average of all Chinese firms will be used to adjust the figure of profitability and revenue growth of firm´s domestic business in sample data. Unrelated environmental impact to firms like Financial Crisis or policy change will be excluded from the sample.

Expected results

First, all the hypotheses are expected to be supported. Moreover, the different magnitude of positive correlations between legitimacy / status / reputation and domestic performance, and the significance level of H1a, H1b and H1c are expected to be discovered in the results.

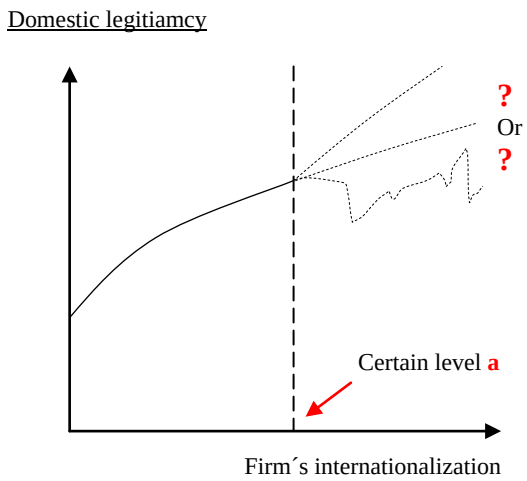

Figure 3 Sample threshold effect of H1a

Second, the positive correlation may have a threshold effect. Take H1a for instance: after certain level of internationalization, the positive relationship may become stronger, weaker or independent as shown in Figure 3. Some detailed questions are expected to be clarified about the threshold effect: where such threshold effect exists, in all three sub-hypotheses of H1 or just part of it? What is the significance level of this effect, if ever it exists? What is the exact effect point? All those questions are likely to be answered until the final results are achieved.

Conclusions

Based on the theory-driven question, whether the indirect incentive effect for firm´s internationalization exists, this paper hopes to make theoretical and empirical contributions. After testing the relationship among internationalization and three domestic social gains – legitimacy, status and reputation and domestic performance in China, the indirect incentive effect is likely to be confirmed and some threshold effects and magnitude differences are expected to be discovered – that will be the major contributions of this paper.

Of course, there are many limitations in this study and a scope of improvement is obvious. For instance, the sample country and industry could be extended and the time interval of research could be increased. Besides legitimacy, status and reputation, some other domestic gains could also be included as control variables. But the value of the topic holds and all those limitations are improvement directions for further studies. This paper hopes to shield some

light about this academic issue and stimulate future efforts.

International and managerial implications

The broader answer for doing international business though only tested with data from Chinese firms, it could be applied to other emerging economies like Brazil and India. Furthermore, the indirect effect is expected to exist in developed economies as well, just with lower magnitude. Not only this paper extends the research scope, it also offers senior managers a comprehensive picture to evaluate the total costs and benefits of internationalization. Thus the result promises managerial implications on optimal decision making and daily operations.

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