# Effect of institutional distance on financial performance of cross border joint ventures with Indian firms

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## Keywords
Institutional Distance(ID), Emerging Market(EM) ,Joint Venture(JV)

**Abstract**
*Institutional theory is gaining visibility in management literature that explores effect of cross country differences of institutions on MNC's behavior and performance.Institutional distance can be defined as the distance between institutions of the countries involved in market transactions. Past studies have focused on the cultural distances between partnering institutions. But the recent literature points towards the need for analysing institutional distance between partnering firms. Emerging market economies have undergone a lot of policy changes. Governance is viewed as key for development by investors. This has increased the demand for monitoring the quality of governance in a country over time. Last decade has seen a series of policy changes in India that has helped in increasing the market access to multinationals. In this study, we will analyse the effect of institutional distance on the performance of joint ventures. It will be insightful to look at the trends of JVs in an institutional setting.*

## 1. Introduction

The last few decades have seen increased partnerships between firms spanned across globe. These associations help them in dealing with rapidly changing environment while remaining competitive. Firms have been increasingly found to form alliances in response to pressures from globalization, customer expectations, and technological advancements. This has resulted in an increased focus on strategic alliances (Culpan ,2009).Internationalization has shifted focus from developed economies to developing economies. Widespread change in policies has made these countries attractive to the companies from mature economies. Developing countries are now said to drive the global economic growth. It is expected that by the year 2030 countries of global south will account for 80 percent of worlds middle class and 70 percent of the consumption expenditure. Table 1 will show the trends in growth of trade volumes in developed and developing economies. In spite of the economic crisis vast majority of equity investors find the growth potential of emerging market companies still appealing. The gains in human development in developing economies are duly noted in 2013 Human Development Report. The report cites rapid growth in India, Bangladesh and other South Asian nations bringing about a shift in global dynamics by helping in expanding the global middle class.

| Trends in Growth in Trade Volumes | | | | |
|---|---|---|---|---|
| | | | (Percent Change) | |
| Particular | 2011 | 2012 | Projections | |
| | | | 2013 | 2014 |
| World Trade Volume (Goods and Services) | 5.9 | 2.8 | 3.8 | 5.5 |
| | | | Imports | |
| Advanced Economies | 4.6 | 1.2 | 2.2 | 4.1 |
| Emerging Market and Developing Economies | 8.4 | 6.1 | 6.5 | 7.8 |
| | | | Exports | |
| Advanced Economies | 5.6 | 2.1 | 2.8 | 4.5 |
| Emerging Market and Developing Economies | 6.6 | 3.6 | 5.5 | 6.9 |

Table1: Trends in Growth in Trade Volumes

Firms opting for cross border trade adopt various modes of entry. Firms may chose to get involved in Mergers & Acquisitions, Joint Venture, and Strategic Alliances or even go for green field ventures. Mergers and acquisition used to be a preferred route of entry into high growth economies. However after the global financial crisis in 2008, companies are taking a relook at effectiveness of buying into emerging market economies. Recent trends shows that access to hard to penetrate markets are gained through joint ventures and strategic alliances.

Joint Ventures (JVs) can be narrowly defined as the common legal organization formed by pooling portion of resources of two or more firms (Kogut, 1988).JVs can be used as a mechanism to hedge against strategic uncertainty (Vernon, 1983).JV is a type of equity strategic alliance (Culpan, 2009).JVs has been a subject of numerous studies (Beamish, 1988; Madhok, 1995).

## 2. Review of Literature and Propositions

**Institutional Distance (ID)**

Influence of systems that surround organizations and shape their social and organization behaviour is emphasised in institution theory (Scott, 1994).Institutions in an economy help to reduce uncertainty and helps establish a stable structure which facilitates interactions .This will reduce the transaction and information costs. Emerging economies characterised by the trends toward open markets but still having regulation provides the institutional influences in developing theories.

Past studies have focused on cultural distances between partnering institutions. The recent literature points towards the need of analysing Institutional Distance (ID) between partnering firms. ID measures help in overcoming the issues faced while using culture scores (Tung & Verbeke, 2010). Emerging market economies undergo a lot of policy changes and deregulation. Governance is viewed as key for development by investors. This has increased the demand for monitoring the quality of governance in a country over time. Institutional theory is gaining visibility in management literature that explores effect of cross country differences of institutions on MNC's behavior and performance (Delios & Beamish, 1999) ID provides an alternative explanation for MNE behavior.

In recent years, Institutional theory has been shown to have a potential to make significant and direct contribution to research on MNEs (Xu and Shenkar,2002). Emerging market have special conditions like relatively poorer, less educated consumers, inadequate market infrastructures. There exists a need to study which creative collaborative arrangements that will help to serve effectively and become successful in these markets (Culpan,2009). Emerging markets are considered as difficult institutional environments-with a key characteristic being that of rapid and sometimes unpredictable changes to regulatory environments. Major emerging economies like India and China in the last couple of decades have seen the development of new institutions and emergence of comparatively stronger rule based interaction of the firms. Such changes can bring about fundamental changes in environment and can influence firms' behavior and performance either directly or indirectly (North, 1990). ID is a useful tool in analyzing all international business relations and is of relevance with respect to emerging economies because of diversities of inward investors (Ionascu *et.al*. 2004).

Scott (1995) points out the distinctive nature of three pillars of institution; Regulative pillar rests on the setting, monitoring and enforcement of rules., Normative pillar prescribes desirable goals and the appropriate means of achieving them., Cognitive pillar highlights the internal representation of the environment by actors. ID can be decomposed into three component parts-regulative, normative and cognitive distances (Xu & Shenkar,2002). World Bank Data can be used to compute six aggregate country governance indicators (Kaufmann *et.al.2005*). These six governance indicators (WGI) can be used to compute ID (Lavie and Miller, 2008).These six indicators developed by Kaufmann *et.al* have been summarised in Table 2.

| Worldwide Governance Indicators(WGI) | |
|---|---|
| Voice and Accountability(VA) | Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media. |
| Political Stability and Absence of Violence (PS) | Reflects perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism |

| | |
|---|---|
| Government Effectiveness (GE) | Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. |
| Regulatory Quality (RQ) | Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. |
| Rule of Law (RL) | Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence |
| Control of Corruption (CC) | Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. |

Table 2: Worldwide *Governance* Indicators (WGI)

*Proposition 1: IJV performance is negatively influenced by the ID between partnering firms.*

**Cultural Distance (CD)**

The decision of formation of a JV also brings together two diverse cultures. The more the divergence between parental firm cultures, the more challenging it become to achieve a fit between them. In cases of International JVs there may even arise a 'third culture' formed by combination of the two original cultures (Ollie,1994).This dynamic process of cultural blending may lead to individual and collective conflicts and this may affect the IJV durability Bener & Glaister,2009). Hofstede & Hofstede (2005) have shown that individuals living in a particular country tend to share similar values and that they bring these values to the firms for which they work. Hence a firm's values are largely a reflection of its national culture. IJV partners based in different countries will therefore tend to have different values. These differences in values may make it more difficult for IJV partners to agree on common goals, solutions to problems and resolution to conflicts than if they came from the same country.

Early works were based on general impression about national cultures (Davidson, 1980).Works of Hofstede (1983) has given an empirically derived, better defined and commonly accepted concept. Table 3 gives a summary of these four cultural dimensions developed by Hofstede. Based on the four cultural dimensions, Kogut & Singh (1988) compiled a composite index for culture.

$$CD_a = \sum_{i=1}^{4}\{(I_{ia}-I_{ih})^2/V_i\}/4$$

CD=Cultural Distance. $I_{ia}$ is the distance index for the $i^{th}$ cultural dimension and $a^{th}$ country .$V_i$ is the variance of the index of $i^{th}$ dimension, h stands for India, and $Cd_a$ corresponds to the cultural distance between the $a^{th}$ country and India

*Proposition 2:IJV performance is negatively influenced by the cultural distance between partnering firms.*

| Hofstede Dimensions(HD) | |
|---|---|
| Power Distance Index (PDI) | The extent to which the less powerful members of organizations and institutions (like the family) accept and expect that power is distributed unequally. It suggests that a society's level of inequality is endorsed by the followers as much as by the leaders. |
| Uncertainty avoidance (UAI) | A society's tolerance for uncertainty and ambiguity; it ultimately refers to man's search for Truth. It indicates to what extent a culture programs its members to feel either uncomfortable or comfortable in unstructured situations. |
| Individualism (IDV) | Individualism is the one side versus its opposite, collectivism, that is the degree to which individuals are integrated into groups. |
| Masculinity (MAS) | Masculinity versus its opposite, femininity refers to the distribution of roles between the genders which is another fundamental issue for any society to which a range of solutions are found. |

Table 3: Hofstede Dimensions(HD)

**Host Country Experience (HCE)**

Importance of experiential learning in a firms' international expansion strategy has been well documented in research (Argyres & Mayer, 2007; Barkema *et al*; 1997; Chang, 1995; Delios & Beamish, 2001). Firms mainly learn through managing their key joint ventures (Tsang, 2002). Experiential knowledge plays a great role in reducing the uncertainty in markets that has different institution base than the home market (Hilmersson & Jansson,2012). Effective transfer of firm specific resources and strategic organizational practices across borders is facilitated by host country experience (Delios & Beamish,2001). Longer experience in operating in a host country gives a firm more knowledge about the culture and institutional environment of the country helping them to adapt easily to the local environment (Luo,1997).

*Proposition 3:IJV performance is positively influenced by the HCE of the partnering foreign firm.*

**Ownership Structure (OS)**

Control in cross border JVs is defined as the ability to exercise authority and influence over the JV's strategic and operational decisions, systems and methods (Anderson & Gatignon,1986). Equity stake is a central element in exercising parent control in a JV (Geringer & Hebert 1989). Satisfactory performance was more prevalent in JVS with a dominant parent compared to those with shared control .Higher level of equity ownership gives a greater degree of control over systems, methods and decisions of its subsidiary to its parent .Higher level of ownership also implies higher level of commitment from the parent company.Cross border JVs with dominant ownership structures minimize transaction costs arising from coordination problems and can outperform ones with shared structure (Killing,1983).

*Proposition4: IJV performance is positively influenced by the foreign parental control.*

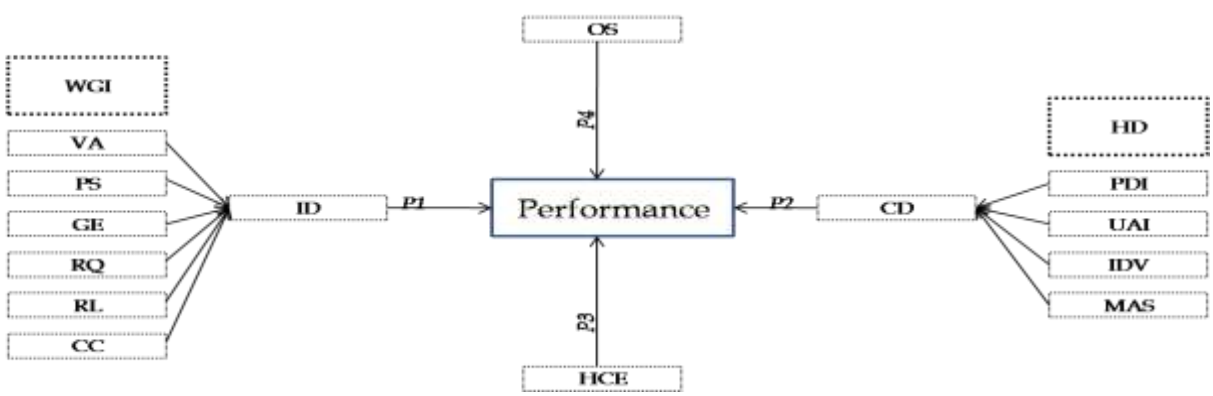


Figure 1:Proposed Model

## 3.Discussion

The performance of a cross border JV may be dependent on several factors. Past studies have focused on the effect of CD on the performance. This paper attempts to highlight the effect of ID on the performance of cross border JVs. The factors that can be used to compute ID has been identified. This would help in analysing the effect ID has on choosing the partners for formation of JVs. The testing of this model will help in identifying the key factors that need to be kept in mind while choosing JV partners. This study focuses on the cross border JVs that has happened with Indian firms during the last decade. Last decade has seen a series of policy changes in India that has helped in increasing the market access to multinationals. This gives us a rich institutional setting to test the proposed model. This study would help in highlighting the most significant institutional measures that helps in attracting the FDI investments through JVs. This would serve as an input to policymaking.

## 4.Future Directions

The proposed model is to be tested by using financial performance measures**.** The analysis of the JVs in last decade help us in understanding the trends observed in an emerging economy. A focused study on the terminated JVs can also be conducted to determined the reasons of terminations. The effect of ID on termination can also be understood by such a study.

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