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PERSPECTIVES

Strategy in emerging economies and the theory of the firm

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Abstract Indigenous emerging economy (EE) firms are increasingly competing in global markets or against multinational corporations (MNCs) in their home markets. But their institutional context at the national and local levels often suffers from what has been termed "institutional weakness" which is believed to put them at a competitive disadvantage on the global playing field. Yet little is known about how EE institutional weakness at the national level translates into competitive disadvantage at the firm level. In this perspectives paper, we examine this shortcoming in the literature. We utilize three popular theories of the firm—*neoclassical economics*, the *resource-based view*, and the *nexus of contracts view*—to examine how EE institutional weakness at the national level affects strategic choices at the firm level. We then explain how these strategic choices affect firm boundaries, internal organization, and the nature of competitive advantage for firms in EEs.

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Emerging economy (EE) firms are increasingly competing in global markets and also find themselves facing foreign multinational corporations (MNCs) at home (Aulakh & Katobe, 2008; Hill & Mudambi, 2010). This creates problems for these firms because their organizational routines and management processes are rooted in local institutional conditions (Brown & Duguid, 2001; Bruton, Ahlstrom, & Obloj, 2008; Hendry, 2000). Jiang and Stening (2013: 478) contend that this mismatch between global markets and local institutions constitutes a "liability of localness" as EE firms face global competitors in their home markets. The institutional conditions in EE countries are sometimes referred to as "weak" in that they are believed to be less conducive to effective and competitive firm governance and management (Bloom & Van Reenen, 2010; Filatotchev, Jackson, & Nakajima, 2013; North, 1993; Wright, Filatotchev, Hoskisson, & Peng, 2005; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). While in some cases EE firms may be able to "springboard" to international competitiveness by acquiring foreign firms or resources (Deng, 2009; Lou & Tung, 2008), this is a short-term substitute for indigenously developed competitive advantage (Bruton, Ahlstrom, & Li, 2010).

Furthermore, most of the literature on business environments in EEs focuses on the societal or national level and several empirical studies indicate that institutions in EEs result in different outcomes (e.g., Aguilera & Jackson, 2003; Chittoor, Aulakh, & Sarkar, 2008; Cuervo-Cazurra & Genc, 2008), but they fail to explain how national-level institutional weakness results in firm-level competitive disadvantage. Thus, in this perspectives paper, we extend the EE strategy scholarship work (e.g., Ahlstrom, Levitas, Hitt, Dacin, & Zhu, 2014; Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004; Hoskisson, Eden, Lau, & Wright, 2000; Peng & Jiang, 2010; Peng, Wang, & Jiang, 2008) in furthering the understanding of how institutional differences affect strategic choices in EE firms.

To achieve this objective, we utilize three popular theories of the firm—the *neo-classical economics view*, the *resource-based view*, and the *nexus of contracts view*—as lenses through which we link national-level institutions to firm-level strategic decisions; theories of the firm are well-suited for examining how local institutions frame the decisions faced by EE firms (Ahlstrom et al., 2014; Ahlstrom, Young, Nair, & Law, 2003). We then explore how decisions of EE firms affect the boundaries, internal organization, and nature of competitive advantage in EEs followed by implications for managers and contributions to research.

Institutions in emerging economies

Institutions have moved from the background to the foreground of strategic management research, particularly when it comes to the strategy in EEs (Ahlstrom et al., 2014; Aulakh & Katobe, 2008; Hitt et al., 2004; Luo, Sun, & Wang, 2011; Peng & Zhou, 2004; Wright et al., 2005). The institution-based view can be thought of as the "third leg" of the strategy tripod (see Fig. 1), which, along with the industry competition view and the resource-based view, explains why firms make strategic choices (Ahlstrom

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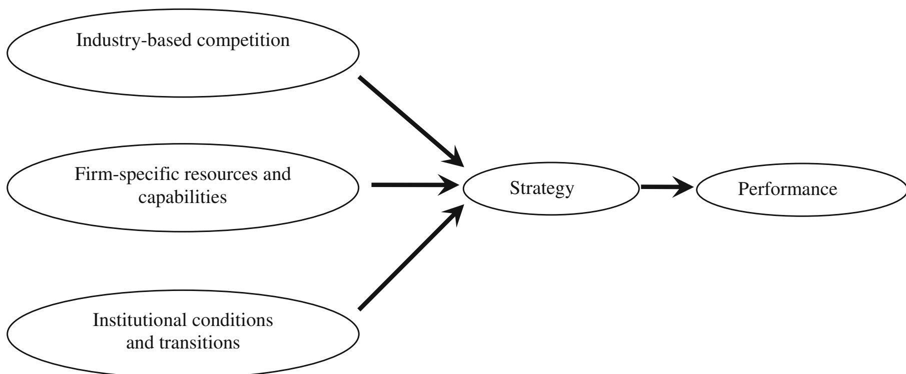

Fig. 1 The institution-based view of strategy: A third leg on the strategy tripod

et al., 2003; Bruton, Ahlstrom, & Wan, 2001; Hitt et al., 2004; Peng, Sun, Pinkham, & Chen, 2009) and whether or how those strategic choices lead to competitive advantage (Peng, 2003; Peng et al., 2008). The institutional perspective is particularly instrumental in explaining differences in strategies and performances between EE firms and developed economy (DE) firms (Hitt et al., 2004; North, 1990; Wright et al., 2005).

Institutions include formal rules (laws, regulations, professional standards, procedures) and informal constraints (customs, norms, cultures), and thus outline the rules for the economic "game" (Garud & Ahlstrom, 1997; North, 1990; Peng & Heath, 1996; Scott, 2014). Institutional theory has been developed with both an economic orientation (Coase, 1992; North, 1990, 1994, 2005; Williamson, 1985) and a more organizational-sociological orientation (DiMaggio & Powell, 1983, 1991; Scott, 2014). Both views agree that institutions structure economic interaction (North, 1990) and place constraints on corporations' strategies (Palmer, Jennings, & Zhou, 1993). Institutions also serve to reduce uncertainty by establishing a stable and enabling (but not necessarily efficient) structure that facilitates economic interaction and development (Acemoglu & Robinson, 2012; Bruton & Ahlstrom, 2003; Garud & Jain, 1996).

EEs are "low-income, rapid-growth countries using economic liberalization as their primary engine of growth" (Hoskisson et al., 2000: 249) and are often in transition from traditional agricultural-based economies or formerly centrally-planned economies. EE firms in Asian countries, most prominently in China and India, are experiencing an emerging dichotomy in society: A segment of society tends to cling to the institutions of the past, while another segment appears to be moving towards more market-oriented institutional structures and processes (Gong, Chow, & Ahlstrom, 2011; Liden, 2012). While relatively less is known about EE firms and their strategies, it is generally agreed that they tend to differ from their DE counterparts (Ahlstrom et al., 2014; Estrin & Prevezer, 2011; Hitt et al., 2004; Hoskisson et al., 2000; Nelson, 1990; Peng, 2000; Shenkar & von Glinnow, 1994). This is due in part to the institutional conditions at the national level that frame strategic decisions at the firm level and influence firm choices and choice sets (Ahlstrom et al., 2014; Hill & Mudambi, 2010; Peng, 2003; Peng & Delios, 2006).

Of course, institutions differ from country to country because of differing cultural and historical lineages (Ahlstrom et al., 2014). But it is still possible to outline general dimensions along which institutions are likely to differ between EEs and DEs (Holmes,

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Miller, Hitt, & Salmador, 2013; North, 1990, 1994). In general, the institutional structures of EEs differ notably from that of DEs in two ways. First, they are less stable (Nelson, 1990; Peng, 2000; Xu, Huang, & Gao, 2012) and second, they are likely to be less conducive to mutually beneficial economic exchange between economic actors (North, 1994; Peng, 2003).

The institutional conditions of EEs are more turbulent than the institutional conditions in DEs (Hoskisson et al., 2000). This is because EEs are in the process of implementing socio-economic systems that often are radically different from the ones that preceded them, such as moving from centrally-planned command economies to market economies (Buck, Filatotchev, & Wright, 1998). In other cases, EEs are moving from rural economies based on traditional, communal system of values to a market system more dependent on individualism and "rationality" (Boisot & Child, 1988; Mangaliso, 2001). In any case, the resulting institutions experience (and can create) turbulence. The institutions also lack legitimacy as the values that support them often are imposed rapidly and exogenously (Ahlstrom, Bruton, & Yeh, 2008; North, 1990, 1993). Increased turbulence also makes strategic planning more and resource allocation more challenging, often requiring novel approaches (Ahlstrom & Bruton, 2002). As Nelson (1990: 17) remarked, "Frequently, the environment in [emerging economies] is so volatile that speculative maneuvering rather than consistent planning is a prominent approach to business" (cf. Baumol, Litan, & Schramm, 2009). This is backed up by empirical studies, which show that, in the case of China, rapid and unannounced changes in policies and regulations often eclipse the original intent of a firm's long-term strategic plans and contingency planning becomes a routine for survival (Ahlstrom & Bruton, 2002; Jiang & Stening, 2013; Peng & Heath, 1996; Peng et al., 2008).

Second, institutions in EEs provide less support for impersonal, cooperative exchange (North, 1994; Peng, 2003). Extending the "rules of the game" metaphor, if institutions are the rules of the game, organizations and their managers are the teams and players that are out to "win the game" outlined by the institutional matrix. The structures and goals of the organizations that come into existence will reflect the choices presented by the "institutional matrix of formal rules, informal constrains, and enforcement characteristics" (North, 1993: 36). The institutional matrix may not promote socially complex, cooperative exchange and economic growth. For example, if institutions (intentionally or unintentionally) reward piracy, then piratical organizations will come into existence (North, 1994). North (1994) added that many societies throughout history have become "stuck" in an institutional matrix that did not evolve into the impersonal exchange necessary for capturing the productivity gains that come from the division of labor, and increased scale and scope. In his later work, North (2005) speculated that Western economies happened to stumble upon an institutional structure that allows for impersonal exchange and specialization and division of labor and that such an evolutionary process is by no means automatic. Recent work in development economics recognizes that there are many variations in economic growth, and that economy-wide growth can often stall after a growth spurt – the well-known "middle-income trap" (Kharas & Kohli, 2011). This suggests that institutional reforms are significant antecedents to sustainable growth and productivity at the firm level (Acemoglu & Robinson, 2012; Ahlstrom, 2010; Hausmann, Pritchett, & Rodrik, 2005).

As the institutional environment influences both internal and external practices and behavior, it also impacts firm innovation (Barley & Tolbert 1997; Baumol et al., 2009;

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Hargadon & Douglas, 2001; Wang, Ahlstrom, Nair, & Hang, 2008). In the context of China, researchers find that the relatively underdeveloped government, legal, and financial institutions in China lead to environmental turbulence as well as dysfunctional competition (Jiang & Stening, 2013; Nee, 1992; Peng & Heath, 1996; Xin & Pearce, 1996). Li and Atuahene-Gima (2001) added that the effectiveness of China's new technology ventures' use of a product innovation strategy may depend not only on how they manage environmental turbulence and dysfunctional competition but also on the degree of support they receive from government institutions to alleviate their resource and managerial problems. Guo (1997) also found that patent and copyright violations, broken contracts agreements, and unfair competitive practices have become widespread in China. The intellectual property rights of new technology ventures resulting from product innovation may be unprotected, making product innovation a highly risky and less profitable strategy (Li & Atuahene-Gima, 2001; Wang et al., 2008).

Formal institutions are thought to be necessary for markets to operate. Yet the market design perspective shows that functioning markets are achievable, even if the formal institutions are weak or incomplete (Krug & Hendrischke, 2012; Peng et al., 2009). Specifically, functioning markets can be achieved when market clearance occurs with each participant finding business partners with no incentives to search for better partners or different organizational or coordination mechanisms. But the outcomes in such conditions will be less optimal than under conditions where the market institutions support impersonal exchange as the players will be limited to dealing only with partners that they trust because they have no institutional recourse if the other party does not honor its contract commitments (Kittsteiner & Ockenfels, 2006; Krug & Hendrischke, 2012).

Essentially, national-level institutions continuously interact with organizations to affect their strategic choices in a dynamic process (see Fig. 2). The dynamic nature and interactions between a firm's internal and external institutions are particularly evident in emerging transition economies (Cui & Jiang, 2012). For example, Cui and Jiang (2012) showed how the home regulatory environment, host regulatory environment, and host normative pressures interacted with ownership structure to impact the decision of Chinese firms when choosing a joint ownership structure when pursuing foreign direct investment (FDI).

A "Theory of the firm" perspective on strategic decisions

Although the focus of this paper is not on decision-making, it is useful to provide some discussion about strategic decision-making processes within organizations. There are several ways to conceptualize decision-making processes and implementation. Hendry (2000) reviewed the traditional, action, and interpretative perspectives on decision-making and asserted that each rests on a different conceptualization of the strategy process. The rational perspective is reflected in the approach taken by textbooks. The decision-making process is comprised of analysis, intentional choice, and implementation. Following this process, the top management is tasked with making the best strategic decisions possible based on the situations they face. The assumptions of this approached is challenged by some researchers, notably Mintzberg, who argues that organizational decisions are neither simple nor decisive and that the evolution of

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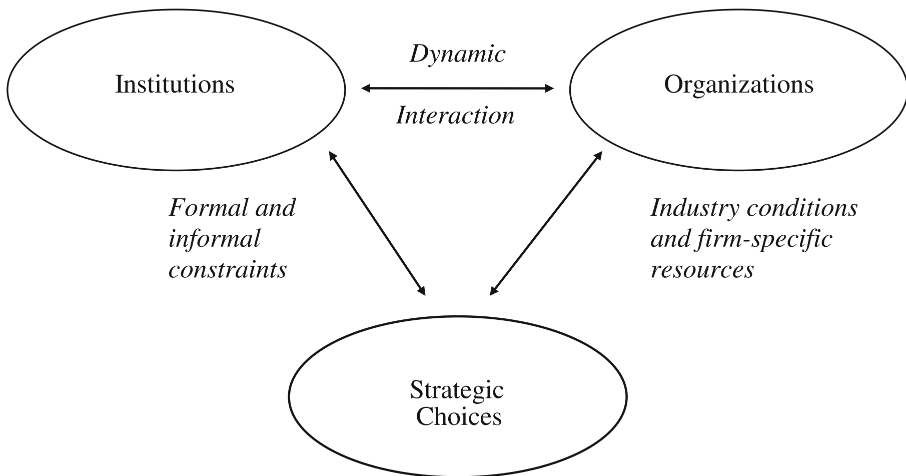

Fig. 2 Institutions, organizations, and strategic choices

organizational commitment is gradual, complex, and for the most part unobservable (Mintzberg, Waters, Pettigrew, & Butler, 1990).

In response, Hendry (2000) conceptualized strategic decision-making as a type of discourse, which is not a prelude to acute organizational change but is an ongoing change process. According to Hendry, it is not enough simply to "make a decision." Rather, a strategic decision takes its meaning from the social practice and discourse in which it is located, and to be effective it must take account of that context. Henry's (2000) integrated perspective on decision-making is probably even more applicable for firms and emerging economies. Thus we adopt Hendry's (2000) strategy as discourse and view the strategic choices as framed by various theories of the firm.

In that regard, theories of the firm provide a perspective for framing organizational objectives and analyzing important research problems (Grant, 1996; Seth & Thomas, 1994), or as Conner and Prahalad (1996: 480) put it, "a theory of performance difference between firms necessarily implies and incorporates a theory of the firm itself." Theories of the firm share certain aspects; they lay the basic theoretical framework for why firms exist, the boundaries of the firms, the basic organizational structure, and—perhaps most importantly—the rationale for competitive advantage (Foss, 1999: 727).

If institutions are the rules of the game, and firms and individuals are the teams and players, then a theory of the firm provides the basic "playbook" that shows the strategic choices available and provides theoretical explanations of how different plays can score a goal and win the game. Thus, the theory of the firm can be used to see how strategic choices are framed for managers in EEs (Bartlett & Ghoshal, 1993; Conner, 1991; Conner & Prahalad, 1996; Foss, 1999; Grant, 1996; Hennart, 1994; Liebeskind, 1996; Poppo & Zenger, 1998; Seth & Thomas, 1994; Wernerfelt, 1984). Theories of the firm are based on previous work in economics by such pioneers as Coase (1937), Jensen and Meckling (1976), or even classical economists such as David Ricardo (cf. Peteraf, 1993).

We now turn to three theories of the firm that have received substantial attention from strategy researchers: (1) the *neoclassical theory of the firm*, (2) the *resource-based view of the firm*, and (3) the *firm as a nexus of contracts* (cf. Conner, 1991; Seth &

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Thomas, 1994). We then explain how they are used to conceptualize the strategic choices that are available to firms. We then demonstrate that, because the institutional conditions of EEs differ from the institutional conditions in DEs, the strategic choices facing firms in EEs differ in systematic ways from the stylistic, textbook model which assumes a DE institutional context.

The neoclassical theory of the firm

The original *theory of the firm* evolved from neoclassical economics (Holmstrom & Triole, 2007). It was a component of a broader theory of value and was used to show how prices allocate resources throughout the economy (Penrose, 1959). As such, the neoclassical firm is essentially a simple production function that combines inputs in the most efficient manner to maximize profits and assumes that there are no transaction costs (Williamson, 1985). Pioneers of industrial organization economics, such as Mason (1949) and Bain (1954), developed the structure-conduct-performance (S-C-P) paradigm which maintains that industry structure determines firm conduct, which, in turn, leads to performance outcomes (Scherer & Ross, 1990). Built on the neoclassical view, the Mason-Bain view of the firm simplifies reality to envision the firm primarily as a perfectly rational simple profit maximizer (Conner, 1991). The neoclassical theory of the firm also assumes that resources are mobile and strategically similar. Since all firms are thought to have access to equivalent resources, the external environment is the main determinant of the neoclassical firm's success or failure; firms attempt to enter market niches that are underserved and then erect and fortify barriers in an attempt to earn "quasi-monopoly rents" (Langlois, 2001).

Michael Porter used concepts from neoclassical economics, most notably the industrial organization (IO) branch, to develop the industry forces model of competition (1980, 1981, 1985). Essentially, Porter advocated "positioning" within an industry's forces in such a way as to reduce the competitive pressures from five forces. As Langlois (2001: 163) put it, Porter developed a framework "for analyzing the ways in which firms could position themselves to gain 'market power' and thus violate the requirements for a static conception of efficiency." More recent approaches to strategic management based on neoclassical/IO economics include game theory (e.g., Aoki, 1984; Brandenburger & Nalebluff, 1995; Saloner, 1991) and innovation and change (Ahlstrom, 2010; Christensen & Raynor, 2003; Hamel, 2012).

How can we use the neoclassical theory of the firm to understand the strategic choices faced by indigenous EE firms? Neoclassical economics is based on the static notion of equilibrium (Jacobson, 1992; Langlois, 2001; Rumelt, Schendel, & Teece. 1991), and thus strategies based on its derivatives, such as the industry forces model, are less suitable for turbulent environments (D'Aveni, 1994). In other words, if the industry structure is changing rapidly, then firm strategies based upon industry analysis may be outdated before they are ever implemented (D'Aveni, 1994). In addition, political maneuvering and the uncertainty resulting from the instable institutional structures may also cause market-based calculations to be ineffective in EEs. If this critique can be aimed at firms in

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DEs, it is likely to be even more accurate when aimed at EEs, where the turbulent institutional environments will make strategy formulation even more difficult.

Another potential difference in basing firm strategy on the neoclassical approach in EEs is the potential adverse effect on consumer welfare. Industrial organization economics is a sub-discipline of neoclassical economics that was originally formulated to improve consumer welfare, with the litmus test of consumer welfare being determined by perfect competition (Scherer & Ross, 1990). Many IO economists are suspicious of these concepts for the purpose of maximizing profit as it increases profits at the expense of consumer welfare as a consequence of strategies that advocate restricting competition (Armstrong & Porter, 2007; Rumelt et al., 1991) or limiting consumer choice (Zhao, Gu, Yue, & Ahlstrom, 2013).

This criticism is applied in DEs with relatively strong market-supporting institutions, such as consumer protection, product liability, and antitrust laws, as safeguards. In EEs that lack such institutional safeguards, then strategies formulated from a neoclassical approach will likely harm consumer welfare with impunity. The institutional structure of EEs is less conducive to mutually beneficial cooperative exchange (North, 1994) and thus more likely to promote activities that encourage corruption, rent seeking, or other forms of value-destroying behavior (Ahlstrom, Young, & Nair, 2002; Baumol, 1990; Mudambi, Navarra, & Paul, 2002; Murphy, Shleifer, & Vishny, 1993).

For example, if a firm uses the (neoclassical) industry forces approach to conclude that it is beneficial to erect entry barriers to limit the threat of new entrants in a DE, the options might include factors such as further product differentiation through. This might include, for example, advertising, as this may discourage new entrants into an industry (Porter, 1980, 1985). But in EEs, with weak market-supporting institutions, other more destructive strategies may be a viable option (Baumol et al., 2009). Thus, an EE firm may be able to pay a bribe to have exclusive access to a market and thus eliminate the threat of new entrants (Acemoglu & Verdier, 2000; Ahlstrom et al., 2002; Nelson, 1990) or in some instances may resort to violence to keep out competition (Young, Bruton, Ahlstrom, & Rubanik, 2011). While such a strategy may, in some sense, be "entrepreneurial" and bring profits to the firm, it will not likely encourage the firm to use scarce resources in the most efficient manner, and such strategies will harm consumer welfare, and in the aggregate will not be beneficial for society (Dougan, 1991; Murphy et al., 1993). For example, Lee and Hong (2012) examined the relationship between corruption and subsidiary profitability in a sample of US MNC subsidiaries located in the Asia Pacific region. They found that MNC subsidiaries located in countries with a lower level of corruption are more profitable. This is likely due to the fact that US firms are prohibited from paying bribes by the Foreign Corrupt Practices Act (2013) and thus may find themselves at a disadvantage to local firms that face no such restrictions.

Applying the "rules of the game" metaphor, firms are simply trying to win the game; if the institutional structure permits or perhaps even encourages consumer welfare-destroying behaviors to win the game, then this is the expected outcome (Ahlstrom et al., 2002; North, 1990, 1994). In summary, encouraging firms to pursue strategies based on frameworks derived from neoclassical economics without first reconfiguring the institutional structure and making it less malleable, may lead to what Baumol (1990) labels as unproductive or even "destructive" entrepreneurial activities.

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The resource-based view (RBV) of the firm

The resource-based view (RBV) of the firm (Barney, 1991; Conner 1991; Wernerfelt 1984), traces its intellectual roots to the work of Penrose (1959) and even to classical economist David Ricardo (cf. Peteraf, 1993). The RBV sees the firm as a collection of various technological, financial, and organizational resources. In contrast to the neo-classical approach, which assumes that resources are strategically similar and highly mobile, the RBV holds that path dependence and resource heterogeneity allows firms to develop core competencies. Over time, some resources may develop into valuable and inimitable capabilities that enable firms to attain sustainable competitive advantage (Barney, 1991, 1997).

Whereas the neoclassical view of the firm focuses on factors external to the firm, such as industry structure, the RBV concentrates on internal factors, namely the acquisition, development, and deployment of heterogeneous resources and capabilities (Barney, 1991). Closely related to the RBV is the idea of *core competencies*—a strategic capability that is valuable, rare, costly to imitate, and not substitutable (Barney, 1991; Peteraf, 1993; Prahalad & Hamel, 1990). A firm following the RBV playbook would first do an internal strategic audit to discover which core competencies it possesses or can develop or acquire and then look for opportunities to exploit them through its complementary organizational routines (Nelson & Winter, 1982). The firm would then take care to continuously nurture and further develop its core competencies (Barney, 1995) and build or develop the needed routines (Becker, 2002; Christensen, 2006).

Using the RBV to understand strategic choices in emerging economies

What can the RBV tell us about strategic choices in EEs? The underpinnings of an RBV strategy hold that a firm can earn above normal returns if and only if it has superior resources. Furthermore, those resources must be protected through some sort of isolating mechanism that prevents their diffusion throughout the industry (Knott, Bryce, & Posen, 2003). In addition, acquiring such resources is path dependent and context specific; acquiring resources is done over time by nurturing relationships among organizational stakeholders that create socially complex and difficult to imitate organizational capabilities (Dierickx & Cool, 1989). For example, White (2000) studied a sample of 163 state-owned Chinese pharmaceutical firms and 73 research organizations to determine how internal and external factors influence how these firms acquire new capabilities. He found that whether firms choose to "make, buy, or ally" in pursuit of new capabilities depends upon both the interaction of the external market conditions and their existing stock of capabilities and experience.

Firm-specific human capital is germane to this process; as Galunic and Anderson (2000: 1) noted, "The resource-based literature has stressed that only firm-specific human capital is likely to generate organizational rents, since those assets are more likely to be inimitable, rare, and therefore a better basis for sustained competitive advantage." But investment in firm-specific human capital is risky for organizational stakeholders as, by definition, it does not have alternative use thus it is more subject to holdup (Williamson, 1985). Stakeholders are more likely to invest in firm-specific capital if they trust other members of the organization as well as the organization itself to not hold them up *ex post* (Barney & Hansen, 1994; Fukayama, 1995). It is easier to

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generate trust in DEs because the institutional structure provides recourse among organizational stakeholders if they face holdup over their firm-specific investments (Barney & Hansen, 1994). Along these lines, Diaz-Hermelo and Vassalo (2010) found that local firms in transition economies often rely on institutional-based strategies for competitive advantage, whereas their foreign counterparts more likely rely on resource-based strategies for competitive advantage.

If the institutional structure is changing and there is less protection for property rights (including protection of intellectual property right) of organizations as well as the members within an organization, then stakeholders have less incentive to invest in firm-specific assets and more incentive to invest in general assets, which can be redeployed elsewhere. In short, the institutional environment of EE provides less incentive for organizational stakeholders to invest in firm-specific intangible assets (North, 1990, 1994; Skaperdas, 1992). This poses problems for firms in EEs hoping to use the RBV playbook because intangible, firm-specific investment is germane to a resource-based competitive advantage (Galunic & Anderson, 2000; Knott et al., 2003).

A second factor when using the RBV playbook in EEs is that the "valuable resources" that firms nurture and create will likely be very different (Guillén, 2000b). Political connections, corruption or deceptive practices may come to be a very important source of a firms' competitive advantage in EEs (Ahlstrom et al., 2002; Nelson, 1990). For example, in Chinese culture, *guanxi* is often viewed as a significant firm resource and this does not have the same negative connotations that it does for Western firms (Tsai, 2002). While intangible resources like political connections are different from what is normally considered as "core competence" from a resource-based perspective, it is clear that such resources are valuable, rare, inimitable, and without substitutes and thus can serve as an important source of supra normal returns in EEs (Fisman, 2001). However, as with the strategies pursued from a neoclassical perspective, they would harm consumer welfare and not be beneficial for society in the aggregate.

The firm as a nexus of contracts

Another well-known theory of the firm views the firm as a "nexus of contracts" (Boatright, 2002; Grossman & Hart, 1986) or more accurately as a "nexus of incomplete contracts" as very few contracts can be specified completely (Coff, 1999; Kim & Mahoney, 2010). Essentially, as the name implies, this theory explains firms' competitiveness by exploring the transactions that go into specifying and enforcing contracts (Hart & Moore, 1990). The *nexus of contracts* perspective traces its origins to Coase (1937), who is often credited with establishing the line of research on the theory of the firm by asking "Why do firms exist?" His answer was that firms come into existence when markets "fail" when market transactions make it impractical for certain exchanges to take place through markets. The nexus of contracts approach can be used to examine the contracts between firms, such as with the transaction cost economics (TCE) approach (e.g., Williamson, 1985) or within firms, such as with agency theory (e.g., Jensen & Meckling, 1976).

The central message of the nexus of contracts theory of the firm is that creating and enforcing efficient contracts reduces transaction costs and that efficient contracts can be

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a source of competitive advantage (Williamson, 1991). As Williamson (1991: 90) put it, "the economizing orientation of transaction cost economics deals with many of the key issues with which business strategy is or should be concerned." In brief, TCE focuses on the transaction as the "basic unit of analysis" (Williamson, 1985). According to this perspective, (1) markets and hierarchies (firms) are alternative means of organizing transactions; (2) transactions undertaken via markets may entail high costs due to uncertainty, opportunism, and other contractual problems; and (3) firms arise because, under some circumstances, they are more efficient in solving transaction cost problems than markets (Coase 1937; Williamson, 1985). A strategy derived from a *nexus of contracts* playbook would attempt to gain an advantage by maximizing efficiency in contracts and transactions. This would involve determining which parts of the value chain could be outsourced given a firm's competitive advantage, and how its costs of transacting compare with those of its rivals (Hennart, 1994; Williamson, 1999).

The nexus of contracts when applied inside the firm focuses on the specification and enforcement of contracts between internal members rather than intra-organizational contracts (Holmstrom & Milgrom, 1994; Jensen & Meckling, 1976). For example, from corporate governance research, agency theory focuses primarily on a particular set of contracts and their resultant transactions—those between firm owners (principals) and the firm's managers (agents). Agency theory posits that the interests of owners and managers are likely to be misaligned, and there is likely to be information asymmetry (Shleifer & Vishny, 1997). Remedies include improving the efficiency of the contract to reduce transaction costs by (1) providing incentives that better align the interests of principals and agents, and/or (2) better enforcement of contracts by monitoring of the agent by the principal, through boards of directors and other governance mechanisms (Eisenhardt, 1989). Agency theory is the predominant paradigm in corporate governance research (Daily, Dalton, & Rajagopalan, 2003; Morck, 2000).

Using nexus of contracts perspective to understand strategic decisions in emerging economies

As with the other theories discussed here, nexus of contracts has been applied mostly to DEs and thus firms from EEs would likely have different outcomes (Hoskisson et al., 2000). Contracts are difficult to specify and enforce even in DEs with relatively stable, market-supporting institutions (Hart, 1993). As discussed earlier, the institutional structure of EEs is less stable and less conducive to efficient transactions, which makes contracts more difficult to specify and enforce. As North (1990: 67) writes, "When we compare the cost of transacting in [an emerging economy] with that in an advanced industrial economy, the costs per exchange in the former are much greater—sometimes no exchange occurs because costs are so high."

The sometimes prohibitively high transaction costs in EEs have three implications for EE firms. First, the boundaries of the firm are likely to encompass more activities, other things equal, in EEs as firms will attempt to economize on transaction costs by having more vertical integration and less outsourcing for activities in the value chain (Coase, 1937; Jones & Hill, 1988). For example, based on case studies of Chinese firms representing different ownership types and during the 1989–1996 period, Peng (1997) posited that in a transition economy such as China, firms adopt a network-based strategy, which he calls "boundary blurring" inter-organizational relationships. This

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"boundary blurring" relationship enables firms to avoid ownership transfer of assets while allowing them access to complementary assets during the transition period (Peng, 1997). Second, it is likely that assets will not have as much transaction specificity. That is, firms will be less likely to invest in assets that are specific to a particular transaction with another organization. For example, Elango and Pattnaik (2007) used panel data from 794 firms to study the role of networks in internationalization of Indian firms. They found that similar experiences of parental and foreign networks help these firms to build capabilities to succeed in international markets.

Finally, hybrid organizational forms, such as business groups and networks, will be more prevalent in EEs because of the prohibitively high transaction costs (Khanna & Rivkin, 2001; Peng, 2003). Along these lines, Garg and Delios (2007) examined business group performance of foreign subsidiaries of EE multinationals and found that advantages associated with business groups are more transferable in other EEs with similar institutional environments.

Agency theory is also derived from the nexus of contracts perspective, but it examines transaction costs *inside* of firms (Jensen & Meckling, 1976). There is considerable evidence that agency theory also behaves differently for firms in EEs when compared to those in DEs (Dharwadkar, George, & Brandes, 2000). For example, Young et al. (2008) developed a model of agency theory in EEs. In this model, the specification and enforcement of principal-agent contracts is prohibitively high due to the institutional environment of EEs. To overcome this, EE firms are more likely to resort to concentrated ownership. This substitutes informal family contracts and relational contracts for the arms-length contracts for professional, hired managers. While this alleviates the principal-agent problems, it creates a new set of problems that Dharwadkar et al. (2000: 665) refer to as "principal-principal agency problems." They use this term because these new conflicts occur between two sets of principals—majority owners and minority owners; concentrated ownership, along with weak protection of minority shareholders, increases the likelihood of minority shareholder expropriation by the majority shareholders (Young et al., 2008). This approach is similar to the "internal market failure framework" recently advanced by Vining (2003).

Strategic choices of firms in emerging economies

Table 1 summarizes the three stylistic theories of the firm along with the outcomes resulting from application to the EE context.

In the following sections, we discuss how using theories of the firm perspective can shed light on strategic decisions in EEs. We focus on three important aspects: boundaries of firms in EEs, how firms in EEs compete, and the nature of competitive advantage for EE firms.

"Double market failure" and the boundaries of EE firms

As noted earlier, Coase originally explained the existence of the firm as a result of the "cost" that emerges from using the market system (cf. Coase, 1993). With this in mind, if the costs of using the market (transaction costs) are higher in EEs, as is generally

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Table 1 Theories of the firm and strategic decisions in emerging economies

Theory of the firm	Basis for strategic choices	How strategic choices are altered in emerging economies
Neoclassical theory of the firm: Views firm as production function, with competitive advantage coming from barriers to entry or protectable niches in the industry.	Managers should attempt to choose attractive industries and then erect barriers to new entrants and improve bargaining power with suppliers and buyers to extract quasi-monopoly rents.	Institutional structure is less stable in emerging economies making it more difficult to plan, analyze and implement strategies. The weak institutional structure may allow more socially-unproductive means for firms to lock out competitors, improve bargaining power, or build scale as a national champion.
Resource-based view of the firm: Views firm as a bundle of heterogeneous resources, with emphasis on acquiring resources that are valuable, rare, and costly to imitate.	Strategies based on RBV would nurture firm-specific resources to obtain core competencies and other capabilities or resources that rivals cannot easily imitate or acquire.	The institutional environment of emerging economies offers fewer incentives for organizational stakeholders to invest in firm-specific organizational capital required for core competencies. This makes it more difficult for indigenous firms from emerging economies to compete in higher value-added industries or activities.
Firm as a nexus of contacts: Views the firm as nexus of contracts, with emphasis on reducing transaction costs for internal and external organizational stakeholders.	Contracts should be specified in such a way to reduce transaction costs, both externally and internally. Firms able to keep transaction or monitoring costs lower than rivals should have a competitive advantage, *ceteris paribus*.	Contracts are harder to specify and enforce in emerging economies, making transaction costs much higher. This likely expands firm boundaries and induces quasi-organizational forms such as business groups. Concentrated ownership and principal-principal corporate governance forms are more commonplace.

considered (Peng, 2001) then the "market failure" explanation has even more validity when applied to EEs. For example, Toulan (2002) provided evidence in support of this notion; using the case of Argentina, Toulan found that vertical integration decreased as the institutional infrastructure improved. Thus, it is likely that Coase's market failure explanation for the existence of firms holds as much as or more validity in an EE context.

However, this is only half of the story as we now know that there are both internal transaction costs and external transaction costs and to remain competitive, firms must weigh the costs and benefits of both types of transactions and make decisions to "make or buy" accordingly (Hennart, 1994; White, 2000). This raises an interesting question: If the "cost of using the market" is higher in EEs as is popularly held (Guillén, 2000a; North, 1994; Peng, 2003; Toulan, 2002), then the why do not the boundaries of EE firms encompass an even more comprehensive set of activities than they currently do? In other words, if North's (1990: 67) contention that the costs of market transacts in EEs are sometimes prohibitively high, then why are not the activities conducted within the boundaries of firms in EEs even more extensive?

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To address this question, keep in mind that there are transaction costs that are external to the firm as well as transaction costs that are internal to the firm (Boatright, 2002; Conner, 1991; Seth & Thomas, 1994). While it is likely that external transaction costs are higher in EEs, it is also likely that internal transaction costs—specifying and enforcing contracts within firms—is also relatively higher (Dharwadkar et al., 2000). This means that EE firms are simultaneously experiencing external market failure (Khanna & Rivkin, 2001) and internal market failure (Vining, 2003; Young et al., 2008)—with failure in this case meaning a relative comparison with the internal and external transaction costs in EE firms with that of DE firms.

Using this "double market failure" framework provides a more thorough explanation for the emergence of quasi organizational forms that surface in EEs, such as networks (Peng, 2003) and business groups (Aulakh & Kotabe, 2008; Khanna & Rivkin, 2001). In the TCE literature terminology, business groups and networks in EEs may be thought of as a sort of "hybrid" between market and organization that strikes a balance between both internal and external transaction costs—analogous to franchises in DEs (Williamson, 1985).

The internal organization of EE firms

What does our approach say about the internal organization of EE firms? First, from the RBV, it is likely that the firm will be less focused on traditional core competencies because, as noted earlier, organizational stakeholders in EE firms lack the incentive to invest in firm-specific assets (Nelson, 1990; Skaperdas, 1992), which are central to the ideal of the RBV (Galunic & Anderson, 2000). Second, it is likely that EE firms are likely to be more externally focused and "entrepreneurial" in that they are constantly looking for new advantages (Jacobson, 1992) to keep pace with the rapidly changing institutional environment (Kittsteiner & Ockenfels, 2006; Krug & Hendrischke, 2012; Nelson, 1990). For example, although the institutional environment of EEs leads to risk and potential failure, new technology ventures will often have a product innovation strategy because such the turbulent environment triggers "unlearning" of current routines and offers novel opportunities (Covin & Slevin, 1989; Hart & Christensen, 2002; Miller, 1987).

Finally, the nexus of contracts view shows that EE firms will likely be more vertically integrated. The nexus of contracts approach also points the way to internal as well as external market failure for EE firms relative to their DE counterparts. This double market failure explains the emergence of the numerous hybrid organizational forms that blur the distinction between firm and market. These quasi organizational forms have unique corporate governance structures (Young et al., 2008), incentive systems (Peng, 2003) and other aspects of internal organization that set EE firms apart from their counterparts in DE.

Competitive advantage in EE firms

Can any generalizations be made about the nature of competitive advantage of EE firms compared to that of DE firms? First, given that EE firms are more likely to rely on general assets (as opposed to firm-specific assets) that are less distinguishable between firms, it is likely that they will rely on institutional environmental factors (as opposed to

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core competencies) as the source for their competitive advantage (Diaz-Hermelo & Vassalo, 2010; Fisman, 2001). And given the malleable institutional environment, the strategies taken are more likely to harm consumer welfare and/or provide negative social benefits in the aggregate (Ahlstrom et al., 2002; Baumol, 1990; Mudambi et al., 2002; Young et al., 2011). In this case, competitive advantage is more plausibly explained form a neoclassical view of the firm, which assumes that firm assets are strategically similar across firms (Seth & Thomas, 1994) and that firms must rely heavily on industry structural characteristics, such as barriers to entry, to obtain superior returns (Porter, 1985). However, the distinction between the RBV and neoclassical view may be blurred in EEs if political connections for erecting barriers to entry become a type of core competence (Fisman, 2001). Second, the nexus of contracts approach would hold that those firms that are successfully able to develop and manage hybrid forms that balance internal and external transaction costs will likely achieve a competitive advantage (Guillén, 2000a; Peng, 2003).

Discussion

Contributions

In this perspectives paper, we have utilized three theories of the firm to explore how national-level institutions in EEs present a set of strategic choices for indigenous firms that may put them at a competitive disadvantage on global markets. This helps to shed light on an important gap in the literature on strategic management in EEs. While it is recognized that EE countries exhibit institutional weakness at the national level, and that EE firms are often at a competitive disadvantage compared with their DE counterparts, there has been very little work that examines how these two phenomena are related. Using this approach, we are able to further the understanding of the boundaries of firms in EEs, the internal organization of EE firms, and the potential sources of competitive advantage for EE firms. This extends research on theories of the firm by highlighting the importance of formal and informal institutions (North, 1990; Peng & Heath, 1996). This perspectives paper examines and amplifies what management researchers have come to recognize—that strategic management in EEs has several unique characteristics that need to be noted (Hoskisson et al., 2000; Peng, 2005; Wright et al., 2005).

Globalization has forced all firms to compete on a global level both at home and abroad. Yet the institutional conditions in which organizational processes and routines are embedded are local (Jiang & Stening, 2013). Managers working in EEs should be wary of management practices based on theories created in DEs that do not carefully consider the institutional conditions facing firms in EEs. For example, it is relatively easier to determine the boundaries of firms, laws, and other conventions regarding interlocking boards, significant cross holdings, insider trading, conflicts of interest, and certain types of collaboration such as price fixing. Yet firm boundaries are less certain in EEs where cross holdings, board interlocks, close government intervention, and unofficial control of one firm by another based on personal connections are not only legal but almost expected (Peng, 2002; Claessens, Djankov, & Lang, 2000). This has confounded firms from DEs as they attempt to form joint ventures with firms from EEs

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(Young et al., 2011). The "rules of the game" are often significantly different in EEs and theories ranging from the macro level to strategy formulation and implementation need to take these differences into consideration. Failure to do so can lead to some costly lessons for firms entering EEs as numerous case studies report (e.g., Ahlstrom et al., 2002; Clissold, 2004; Volkov, 2002).

Similarly, this perspectives paper points out key differences in how firms are defined and operate in EEs. Indefinite indigenous firm boundaries in EEs owing to cross-holdings or unofficial control of one firm by another can lead to empirical problems in understanding strategy and measuring performance. Researchers, like investors, are often confused by sudden and unexpected shifts in ownership of assets as majority owners often "tunnel" key assets from a public-traded firm to a privately held firm owned by the majority owners (Young et al., 2008).

Limitations and future research

One limitation of this perspectives paper is that we have not addressed the question of whether institutional convergence is taking place across different countries. There is an ongoing debate regarding institutional development in EEs concerning the extent to, and/or the rate at which, institutions in EEs are converging toward those of DEs. Some scholars contend that institutions are converging toward the Anglo-American model relatively quickly (Rubach & Sebora, 1998). Much of the pressure seems to come from the international investment community, which has a stake in promoting more transparent corporate governance (Allen, 2000). However, not everyone agrees with the rapid convergence hypothesis. For example Guillén (2000b) argues that institutional convergence is moderated by domestic politics in ways that make convergence across countries unlikely to occur anytime soon. Still others argue that a partial convergence is taking place. Liden (2012) maintains that in China and India, there is a segment of society that is clinging to the institutions of the past, while there is another segment that appears to be moving towards more market-oriented institutional structures and processes. Young, Ahlstrom, and Bruton (2004) found that, even within a single firm, partial convergence is taking place. Drawing on interviews with several prominent Asian managers and investors, they found that institutional convergence is greatest in areas where EE firms interface with the global economy (e.g., investor relations and financial reporting) and that institutional convergence is lagging in areas where international contact is missing (e.g., TMT compensation and HRM policies).

Another limitation of this perspectives paper is that in order to be comprehensive, we over generalized the institutional conditions that exist in EEs, which are a very heterogeneous group even within the same geographic region (Hoskisson et al., 2000). While it is true that institutional conditions share enough characteristics that it is possible to generalize regarding similarities among their market institutions, there are still many rich institutional and cultural differences (Gammeltoft, Barnard, & Madhok, 2010; Lou, Sun, & Wang, 2011; Wright et al., 2005). For example, both indigenous Chinese firms and indigenous Brazilian firms may have institutional structures that provide less support for "impersonal cooperative exchange" between economic actors, but the institutional factors underlying each case are likely very different. Thus, each case would require a different approach to overcome the specific limitations inherent in that case. A possible next step for EE researchers with interests in a particular

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geographic or cultural area would be to develop a *theory of the firm* that takes into account the institutional detail of a more narrowly defined institutional domain. For example, it might be possible to reveal a theory of the firm in one of the most significant EEs that might more accurately depict its specific institutional conditions.

In terms of future research, this paper has sought to combine perspectives from both economics and strategic management to uncover new potential areas for research. First, researchers may want to explore the explanation of business networks and business groups as hybrid forms that emerge as a result of "double market failure" that occurs in EEs. Viewing them in this new light may open up previously unexplored avenues for new research. A second potential area for research is the nature of competitive advantage for EE firms. Although the ethics of the source of profits has been examined in the management literature (Foss, 1997), this is more of a contentious issue in EEs (Tsai, Young, & Chan, 2011). What may be considered as corruption in DEs may be considered a legitimate source of competitive advantage in EEs (Chen, 2001; Fisman, 2001). Finally, it is possible that strategic management researchers may be able to contribute to literature on development economics. While much of the research on development economics focuses on macroeconomic factors, some of the research focuses on microeconomic factors (Meir & Rauch, 2000). Strategic management researchers that examine strategy in EEs, with knowledge of organizational best practices, may be able to contribute to this conversation. Additional potential topics for research include innovation and the performance of entrepreneurial firms in EEs and helpful institutions such as venture capital and microfinance (Ahlstrom & Ding, 2014; Bruton, Ahlstrom, & Singh, 2002; Newman, Schwarz, & Borgia, 2014; Wong, Ho, & Autio, 2005). Finally, the importance of family firms cannot be overlooked in EEs, particularly the value of social capital (Lu, Au, Peng, & Xu, 2013) and its limits (Ahlstrom, Young, Chan & Bruton, 2004; Su & Carney, 2013)

Conclusion

Many EE countries have made enormous strides in recent years in lifting millions of people out of poverty. Yet despite the undeniable advances at the national level, the fact is that productivity remains much lower in EE firms (Bloom, Mahajan, McKenzie, & Roberts, 2010). There is growing concern that many EEs may get stuck in the middle income trap (Kharas & Kohli, 2011) and fail to introduce market-friendly institutions and effective management practices (Bloom & Van Reenen, 2010). Researchers have come to realize that the institutional structure of EEs is a big factor in hindering their continuing progress (Acemoglu & Robinson, 2012). While globalization of markets is proceeding rapidly, there is a lag in institutional structures, which are based on culture and accepted norms and therefore can only change slowly, if at all (North, 1994). In short, this has created problems for EE firms as they are being forced to compete in global markets, but the institutional context of their organizations and routines, and hence their potential competitive advantages, are embedded in local institutions (Jiang & Stening, 2013; Porter, 1990). It may be that bridging the gap between global markets and local institutions is perhaps the biggest challenge that globalization poses to EE firms and organizational researchers in the field.

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This perspectives paper has utilized the "theory of the firm" to link national-level institutions to firm-level strategic decisions. This approach shows that the institutional matrix at the national level creates a different set of choices for managers of EE firms. These strategies are rational given the institutional structure faced in local environments, but the strategies may not be competitive in global markets and are not conducive to maximum societal benefit in the aggregate. The competitive disadvantage of EE firms is not because managers there are less talented or hard-working, but because they face a different set of choices (Liu, Wang, Zhao & Ahlstrom, 2013). The novel approach taken in this perspectives paper sheds further light on this gap between global markets and local institutions. With improved understanding of the boundaries, the nature of competitive advantage and internal organization of EE firms, researchers, practitioners, and policy makers can take steps to allow them to increase productivity and compete on an equal footing in global markets.

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