Narayanan, V.K. and Fahey, L.

The relevance of the institutional underpinnings of Porter's Five Forces Framework to emerging economies: an epistemological analysis


Staff and students of Anglia Ruskin University are reminded that copyright subsists in this extract and the work from which it was taken. This Digital Copy has been made under the terms of a CLA licence which allows you to:

* access and download a copy;
* print out a copy;

Please note that this material is for use ONLY by students registered on the course of study as stated in the section below. All other staff and students are only entitled to browse the material and should not download and/or print out a copy.

This Digital Copy and any digital or printed copy supplied to or made by you under the terms of this Licence are for use in connection with this Course of Study. You may retain such copies after the end of the course, but strictly for your own personal use.

All copies (including electronic copies) shall include this Copyright Notice and shall be destroyed and/or deleted if and when required by Anglia Ruskin University.

Except as provided for by copyright law, no further copying, storage or distribution (including by e-mail) is permitted without the consent of the copyright holder.

The author (which term includes artists and other visual creators) has moral rights in the work and neither staff nor students may cause, or permit, the distortion, mutilation or other modification of the work, or any other derogatory treatment of it, which would be prejudicial to the honour or reputation of the author.

This is a digital version of copyright material made under licence from the rightsholder, and its accuracy cannot be guaranteed. Please refer to the original published edition.

Licensed for use for the course: "Strategic Management Analysis".

Digitisation authorised by Sarah Packard

ISSN: 0022-2380
The Relevance of the Institutional Underpinnings of Porter’s Five Forces Framework to Emerging Economies: An Epistemological Analysis

V. K. Narayanan and Liam Fahey
Drexel University, Philadelphia; Babson College, Massachusetts

ABSTRACT Using the Toulmin method, we present an epistemological analysis of Porter’s Five Forces Framework (FFF) in light of the increasing evidence pertaining to the institutional context in emerging economies. The analysis reveals three key qualifiers in the theoretical structure of FFF – transaction costs, capital flows and laws governing rivalry. Evidence from emerging economies indicates that FFF’s assumptions about the qualifiers are not met in these economies. Indeed, firms in these economies adopt strategies not derivable from FFF to tackle their unique institutional contexts. Our Toulmin analysis helps pinpoint the directions for further research in emerging economies. Specifically, the three qualifiers provide a meaningful way of building typologies and taxonomies to accommodate the diversity of institutional contexts and to link them to firm-level strategies. Our discussion also highlights the need to turn the spotlight on laws governing rivalry, a relatively underexplored topic in emerging economies, and the effectiveness of different network strategies.

INTRODUCTION
Accumulating empirical evidence suggests that at least some strategic management models originating in developed economies do not necessarily fit the conditions prevalent in emerging economies. Nelson (1990), for example, highlighted the failure of popular strategy concepts when applied in Brazil, and enumerated several effective strategies not embraced by these concepts. Peng and Luo (2000) demonstrated how, along with traditional strategy variables, social ties explained the performance of their sample of Chinese firms. Both these and other scholars (for a review, see Hoskisson et al., 2000; Wright et al., 2005) have identified several
significant differences in the institutional contexts between developed and emerging economies, which may restrict the applicability of the dominant strategy models in emerging economies.

The institutional contexts prevailing in emerging economies call into question the critical assumptions underlying the models originating in developed economies. We address this central issue in the case of Porter’s Five Forces Framework (FFF), arguably the best known and most widely applied analysis framework in strategic management. As the most referenced management scholar (Davenport and Prusak, 2003), Porter has had immense influence on the strategy field. FFF, however, exemplifies the tendency of strategy models to take as a priori assumptions the characteristics of developed economies – the institutional context in which it was incubated. Unfortunately, these assumptions have increasingly become tacit, and thus less likely to be explicited and subjected to analysis when strategy models are applied in emerging economies.

Although Porter’s own thinking has evolved over the years to incorporate institutional forces (Porter, 1992, 1998), and the research on emerging economies has invoked different theoretical frameworks, the original FFF or its variations feature prominently as a base model in most strategic management text books and courses. The boundary conditions continue to be left implicit, and FFF gets treated through the prism of free market economies. Rarely does a critique of the original FFF get played out in traditional capstone courses. For example, Dunning’s (1993) criticism of Porter’s ‘very ethnocentric US way of looking at the world’ (p. 12) – a criticism echoed by others (e.g. Rugman and Verbeke, 1993) – or strategies to directly influence the government that contradict Porter’s view of the role of the government as ‘indirect, partial and . . . observable after a substantial lapse of time’ (Grant, 1991a, p. 543) are not always featured in the classroom.

The increasing output of a new generation of scholars who focus on emerging economies renders it possible to conduct an epistemological analysis of FFF to examine the applicability of its underlying assumptions in emerging economies. Since these scholars have invoked theoretical bases different from Porter, especially the institutional, resource-based and agency theories (Hoskisson et al., 2000), their works provide a dialectical tension (Churchman, 1971) necessary to grasp the assumptions within FFF. The insights from this epistemological analysis should result in specifying the boundary conditions for the applicability of FFF in emerging economies.

Although there have been some calls to revise FFF (cf. Dunning, 1993), we are not aware of any effort to apply epistemological tools to derive FFF’s underlying assumptions and examine their efficacy in emerging economies. We deploy Toulmin analysis – a tool in the epistemological arsenal for critical analysis – to characterize the underlying theoretical structure of FFF and to represent the critical assumptions pertaining to the institutional fields evident in developed economies upon which the model stands. An outgrowth of the analysis is not
merely greatly augmented appreciation of the theoretical boundaries of the Porter model, but an enumeration of alternative theoretical directions for building frameworks of strategy in emerging economies.

Our analysis unfolds in four sections. In the first section, we summarize the major features of the institutional context of emerging economies to juxtapose against the implicit assumptions in Porter’s FFF. Second, we use Toulmin analysis to structure the key institutional-level assumptions underpinning FFF in light of the evidence from emerging economies; these assumptions serve as qualifiers (in Toulmin’s terms). The violation of these assumptions in emerging economies is at once a critique and a call for developmental work in theory building. Third, we outline the theoretical implications for strategy work in emerging economies underscored by the Toulmin analysis. Fourth, we sketch the implications for short and long term strategic alternatives in emerging economies; this enables us to both highlight and restrict the applicability of FFF. We conclude by highlighting the need for further epistemological work to advance theory and research on emerging economies.

THE INSTITUTIONAL CONTEXT OF EMERGING ECONOMIES

Conceptualized as the ‘rules-of-the-game’, institutions are ‘the humanly devised constraints that structure human interaction’ (North, 1990, p. 3) that may include formal rules and informal constraints. As emerging economies evolve, institutional structures move from ‘relationship’ contracting to ‘arms-length transactions’ (Peng, 2003) or, in other words, from relationship-based personalized exchanges to those that are rule-based and impersonal with third party enforcement. In North’s terms, formal rules replace informal constraints. Thus a fundamental difference between emerging and market economies is the existence in the latter economies of ‘market-supporting’ formal institutions (Peng, 2003; World Bank, 2002).

We will restrict our discussion of the institutional context in emerging economies to the development and operation of an interconnected web of legal, financial and regulatory institutions. Indeed, some or all of these institutions have been featured in the scholarship on the management of emerging economies, including countries in Central and Eastern Europe such as the Czech Republic (Clark and Soulsby, 1999; Kogut and Spicer, 2002) and Russia (Kogut and Spicer, 2002); in Asia such as China (Jefferson and Rawski, 1995; Peng, 1997); and in Latin America including Chile and Brazil (Nelson, 1990). Our reference to institutions embraces their operation in addition to their existence. That the operation of an institution may differ from its original charter either through neglect or intent is an occurrence witnessed even in developed economies (see for example, the operation of Antitrust in the United States (Narayanan and Oxandale, 1990)). There is already some evidence of this effect in the inconsistent use of accounting systems in the case of firms in Russia (Skate Press, 1998).
Emerging economies are not homogeneous, and indeed display a rich variety of institutional contexts (Djankov and Murrell, 2002). Hoskisson et al. (2000) have underscored this institutional heterogeneity among countries within the same geographic region and even among countries such as the now independent republics of the former Soviet Union that had a largely common starting point. However, since our concern is the conceptual differences in institutional contexts between emerging and developed economies, we will focus only on those facets of diversity that constitute the central, taken-for-granted assumptions of Porter’s FFF.

In summary, a key difference between the developed and emerging economies is the existence of market supporting formal institutions in the former and their absence to varying degrees in the latter economies. This crucial difference has profound implications for the applicability of Porter’s FFF. To structure this discussion, we turn to Toulmin analysis, a methodological tool that enables an epistemological analysis of any theoretical scheme.

AN EPISTEMOLOGICAL WINDOW INTO PORTER’S MODEL

The epistemological claims of any strategy frame – theory, model or framework – to ‘knowledgehood’ (that is, a body of knowledge worth taking seriously) rest on the cognitive enterprise on which the claims are founded. As noted by Rescher (1992), the quality of this cognitive enterprise rests on a rational discourse that ensures the existence of persistent and pointed challenges to key elements in the reasoning process. This in turn requires an (epistemological) methodology to structure the arguments constituting a frame that ties together analytical constructs, explicit or implied causal connections, relevant evidence, and perhaps most critically the underpinning assumptions (that unfortunately often remain largely implicit). It is for this purpose that we now invoke Toulmin’s approach to epistemological analysis.

Toulmin Analysis

The Toulmin method (Toulmin, 1958) makes explicit that every strategy frame must start with three core items: descriptive data (D), outputs or claims (C) in the form of conclusions, implications or prescriptions, and propositions or warrants (W) in the form of principles or rules that enable the strategy theorist or manager to get from D to C. The argument, i.e. the logic or reasoning that enables the strategist to get from D to C is rarely self-evident or transparent. For example, Porter’s Five Forces Framework (FFF) requires extensive descriptions (D) of (for example) the relevant industry, or competitive space, and the roles, positions, and strategies of various rivals. However, such data (D), no matter how comprehensive or detailed, do not explain the claims (C), that is, the inferences, recommendations, or assertions, derived from the Porter strategy frame.

© Blackwell Publishing Ltd 2005
Thus, warrants (W) demand that the theorist or manager explicate the propositions, that is, the statements in the form of strategy-relevant rules or principles that serve as the necessary bridges between D and C. The Toulmin method, however, cautions that any advocated warrant (W) be examined for its backing (B): What historical evidence supports the proposition? What other principles or rules support the warrant? The backing (B) typically takes into account descriptive data that are different from the D that buttresses the specific C in question. As B is explicated, our understanding of the argument at the heart of the strategy frame is further refined and enhanced.

Further, Toulmin analysis recognizes that the underlying argument may hold with varying degrees of strength across different contexts. Thus, we need to examine the degree of force that the data (D) confer on the claim (C) by virtue of one or more warrants (W). In other words, we must identify the relevant qualifiers (Q) to an argument, thereby refining the domain and range of applicability of any strategy frame. Qualifiers thus represent the boundary conditions within which a theoretical scheme can be employed to yield valid inferences. Thus it forces the question: What are the circumstances in which the argument (and specifically the warrant) does not apply – it must be set aside? In other words, what are the conditions of rebuttal (R)?

In summary, Toulmin analysis provides a method by which to examine the underlying structure of argumentation, especially the assumptions (Mason and Mitroff, 1981) at the heart of any strategy frame. We will use it to illuminate the theoretical structure of Porter’s FFF especially with respect to its backing and qualifiers.

**Toulmin Analysis of Porter’s Model**

For scholars invoking the competition-based view of strategy, Porter’s FFF (Porter, 1980, 1985) provides one strategy frame to generate the warrants necessary to move from industry/firm level data to strategy relevant conclusions. In his development and articulation of the model, Porter (1981) acknowledged his intellectual indebtedness to advances in industrial organization (I/O) economics in general, and in particular, to the Bain/Mason paradigm (Bain, 1968; Mason, 1939). In short, arguments derived from the Bain/Mason paradigm constitute the core of the necessary warrants underpinning his model. And, most importantly, the empirical backing (B) supporting these warrants was indeed impressive. To quote Porter directly:

Bain also pioneered an empirical tradition of statistical studies relating aspects of industry structure to conduct and performance (usually profitability). Literally hundreds of studies of this form . . . have formed the backbone of IO literature. (Porter, 1981, p. 611)
Although there are differences between IO economics and Porter’s notions of strategy in terms of the objectives (competition or antitrust policy versus business strategy), unit of analysis (industry versus the firm), methodologies (nomothetic versus idiographic), and even model formulation (deterministic versus co-determined), Porter transported ‘structure’, ‘conduct’ and ‘performance’ – the central constructs of the I/O model – to his FFF. In a series of influential books (Porter, 1980, 1985, 1990), Porter elaborated upon his model and demonstrated its utility with the help of several well-crafted case studies (1983).

FFF aims to capture the economic forces shaping rivalry in an industry. The model incorporates three key sets of elements: (a) bargaining power with customers and suppliers, derived from the economics of the extended value chain; (b) the economics of the operation consisting of initial capital requirements, economies of scale and experience curve effects that influence entry and growth; and (c) extended rivalry (incumbents, substitutes and potential entrants), driven by the quest to achieve competitive advantage. Porter separates exchanges with suppliers and customers, and isolates competition from potential entrants, substitutes and incumbents; hence his model has five elements or forces. For Porter, these forces determine the attractiveness of an industry for investment, and inform decision makers about feasible avenues to manage competitive dynamics. Porter (1981) was also quick to point out that the FFF captures only one of the four elements of effective strategy formulation – industry opportunities and threats – identified by the then prevalent Harvard model (Andrews, 1971).

Although the FFF, by Porter’s own admission, does not explicitly address the institutional context, it can however be used to derive the institutional elements.
that could critically affect its applicability. The three sets of elements – bargaining power of suppliers and customers, economics of operations and extended rivalry – central to FFF respectively reflect three key features of the institutional context: transaction costs, capital flows and laws governing rivalry. Since FFF tacitly embeds institutional assumptions about these boundary conditions from developed economies, it invites rebuttal in emerging economies (see Figure 1). Thus the three institutional features, each pertaining to one of the three central elements of FFF, in effect emerge as qualifiers \( Q \) to the Porter model; each is discussed below.

Transaction costs. Our discussion of the influence of transaction costs is anchored in North’s (1990) original insight into the relationship between institutional maturity and transaction costs. As Coase (1960) taught us, gathering information, making decisions about whom to bargain with, and how to protect contracts once agreed upon – activities that underpin the bargaining with customers and suppliers – all impose significant costs and risks. As later elaborated by North (1990), these costs include both the costs of search, measurement, policing and enforcement, and an ‘uncertainty discount reflecting the degree of imperfection in the measurement and enforcement of the terms of exchange’ (p. 62).

Given its intellectual indebtedness to IO economics, Porter’s FFF is silent on transaction costs with customers and suppliers (and by implication with other stakeholders such as financial institutions). By default, in FFF, these transaction costs are assumed to be only a small portion of the total costs; hence, for practical purposes, transformation costs (in the economic sense) are the only costs that matter.\(^1\)

The influence of transaction costs may be too significant to be ignored in emerging economies, a recognition that permeates the scholarship on emerging economies (e.g. Henisz, 2000). Broadly, in many of these economies, the institutional framework lacks the formal structure and enforcement that underpins efficient markets (North, 1990, p. 67). Specifically, the opacity of information in emerging economies due to the existence of ‘institutional voids’ (Khanna and Palepu, 2000; see also Choi et al., 1999) imposes high search costs on firms, unless they can devise mechanisms to overcome them through personal ties. Also, the absence of third party contract enforcement mechanisms or intellectual property laws in emerging economies has been well documented in the literature (Djankov and Murrell, 2002; Frye, 2001). According to North (1990), since emerging economies often lack a stable institutional structure to facilitate economic exchanges and to reduce their uncertainty, they suffer from higher ‘costs per exchange’ than developed economies. This idea is effectively used by Peng (2003) to argue that the benefit/cost calculus shifts favourably toward arms-length transactions during institutional transitions, as transaction complexity increases.

© Blackwell Publishing Ltd 2005
Although in these economies some informal sectors based on personalized exchange system may enjoy low transaction costs, these sectors are condemned to be small and, therefore, to suffer from high transformation costs (North, 1990). They are thus unable to benefit from the FFF type analysis built upon, among other factors, efficiencies to be gained from scale of operations. Even the Western businesses that may enjoy scale efficiencies and thus lower transformation costs, face high transaction costs while entering emerging economies, as underscored in Meyer’s study (2001) in Eastern Europe: ‘they lack information about local partners, they must negotiate with agents inexperienced in business negotiations, and they face unclear regulatory frameworks, inexperienced bureaucracies; underdeveloped court systems and corruption’ (p. 358).

North’s ‘uncertainty discount’ that enhances transaction costs in emerging economies – arising from institutional underdevelopment – helps us to explain three strategic mechanisms firms employ to manage this uncertainty, none of which are recognized in FFF. The first focuses on interpersonal trust (Chiles and McMackin, 1996) as a factor in the selection of partners in exchange relationships, especially when the exchange is infrequent or short lived; here trust overcomes opportunism (Beccerra and Gupta, 1999). The second focuses on the emergence or development of relatively stable networks – sometimes through cross-ownership (Kogut et al., 1992) – as a solution to the problem of opportunism, especially when the members engage in repeated exchanges. For example, in his analysis of transitions in Eastern Europe, Stark (1996) argued that after the collapse of Communism, the informal and inter-firm linkages that were activated by prevailing networks of affiliation actually ‘got the job done’ (p. 994). Similarly, Meyer and Estrin (2001) attribute brown field entry by Western firms to emerging economies as a tactic designed to acquire embedded networks of exchange. The third mechanism is the development of private enforcing schemes, including the ‘Mafia-type organizations relying on physical force’ (Dunbar et al., 1994). In the absence of these mechanisms, as transaction complexity increases, the bargaining power is likely to shift upstream: suppliers may be able to enjoy the fruits of ‘hold-up’ (Ghemawat, 1991) without attendant legal penalties.

Capital flows. The institutional arguments pertaining to capital flows in and out of industries suggest that to the extent financial, legal and regulatory institutions do not provide investors the opportunity to reduce the risks of loss of capital or wealth, as in emerging economies, capital flows are slow unlike in market economies (e.g. Nelson, 1990; financial economists, Rajan and Zingales, 2003; and management scholars, e.g. Khanna and Palepu, 2000; Kogut and Spicer, 2002). Theoretical spotlight is on the institution development that promotes intellectual property rights (Isobe et al., 2000), information transparency (Kogut and Spicer, 2002), risk cushions via bankruptcy laws (Gropp et al., 1997) and risk capital through venture capital or junk bonds (Rajan and Zingales, 2003).
As in the case of transaction costs, Porter’s FFF does not address the flow of capital, but transports the IO assumption that competition among current look-alike rivals and with potential look-alike and substitute entrants ensures over time that the industry achieves its risk-adjusted normal returns. The risks are entirely economic; they reflect prevailing rivalry conditions in the respective product markets. Capital flows smoothly from low return industries to high return industries, resulting in exit and entry of firms. But in emerging economies the capital flows that are crucial to entry and exit may be slow due to the absence of a supportive institutional framework. The absence of institutions dealing with risk capital and the lack of protection provided by US type bankruptcy laws (Spicer et al., 2000) may inhibit entrepreneurial start-ups as in the case of Portugal, an emerging economy in the European Union (Hoskisson et al., 2000). Second, underdeveloped capital markets and governance structures may not generate enough confidence within the relevant local population without privileged access to information to undertake participation. Thus entry and exit patterns are likely to deviate somewhat from the prescriptions of Porter’s FFF. Capital flows are likely determined not merely by industry attractiveness, but by the embedded socio-economic structures: who you know may be as important as whether you have the requisite knowledge and capabilities to enter.

Evidence from emerging economies indicates the viscosity of capital flows. First, the lack of regulation and transparent market prices may make it difficult to detect or prosecute the stripping of firm assets for personal gains (Spicer et al., 2000), to the detriment of ordinary shareholders. This has been observed in Russia and the Czech Republic (Hoskisson et al., 2000; Kogut and Spicer, 2002). Second, access to capital becomes a strategic necessity to enter, which gets played out in many ways. For one, foreign investment is frequently a way of accessing resources, both capital and others. Alternately, for potential local entrants without access to foreign investment, ‘reputation’ effects may be necessary to obtain finances, which itself may often be a function of size, and the centrality of location in socio-political networks. For foreign entrants, access to capital may not be a problem, but the lack of property right regimes in emerging economies may increase the risk premium built into the cost of capital over and beyond the market risks. Third, in the absence of well developed capital markets, individual firms may develop internal markets through diversification, partly as a way of transferring resources from less productive to more productive industries (Khanna and Palepu, 2000).

**Laws governing rivalry.** A third facet of institutional context is the legitimacy of competition that is both nurtured and enforced. The focus here is on the laws governing rivalry that is at the heart of most market economies: How does a state ensure that economic bases of competition prevail rather than ‘unfair trading practices’? Although less developed in the emerging economy literature, the existence of contraband trade is recognized, for example in Brazil (Nelson, 1990), and along
with it the recognition of the need for at least one facet of legitimate rivalry: strong intellectual property regimes that are a ‘safeguard against the illegal use or application of patented technology and copyrights by local imitators’ (Isobe et al., 2000).

The FFF presumes that rivalry in its economic form is not impeded by forces ‘external’ to the product marketplace. The model transports, perhaps inadvertently, a dominant assumption of Bain/Mason paradigm (Bain, 1968; Mason, 1939): legally enforced rules pertaining to Antitrust (e.g. price discrimination, collusion and unfair trade practices) and to intellectual property ensure that firms do not have to worry about unfair means of competition. However, moving beyond the established institutional confines of advanced economies calls into question this pivotal assumption. In emerging economies laws pertaining to legitimate rivalry may not exist and the informal norms may not be readily transparent. This absence of laws may alter the nature of competitive rivalry in emerging economies.

When formal rules are not evidently in force, much of Porter’s discussion of competitive signalling (1980) simply does not apply. However, competing firms can manage the competitive uncertainty through several mechanisms, not recognized in FFF. For one, they can privately communicate with one another without incurring severe legal penalties. For example, competing firms can cooperate (Stark, 1996) through such mechanisms as cross-ownership (Kogut et al., 1992). Alternately, they can use the socio-political networks between firms’ managers and government agencies to thwart existing or new competitors. Thus Doh (2000) described how the Mexican government provided protection to the Telmex consortium partly by charging new carriers to help Telmex pay for long distance network improvements, and by charging high interconnect fees.

**Summary.** In our Toulmin analysis of the FFF we adopt the conditions pertaining to transaction costs, capital flows and legitimate rivalry as the central institutionally based qualifiers, as illustrated in Figure 1. In fairness to Porter, the three qualifiers were taken for granted, since his primary focus was on well-established firms, where managers essentially controlled the firm, and the shareholders typically wielded relatively limited power. The qualifiers were a reflection of the free market ethos of the United States that pervaded in most of its industries. As Porter himself noted, international trade and competition was something that had to be ‘built into’ IO models (Porter, 1981, p. 616). However, as we have shown, once we leave the USA, and enter the emerging economies, the three qualifiers deviate from the implicit assumptions of Porter’s FFF.

**IMPLICATIONS FOR THEORY AND RESEARCH**

Our Toulmin analysis of Porter identified three qualifiers that are shaped by institutional context: transaction costs, capital flows and legitimate norms of rivalry,
and our discussion of the applicability of Porter’s FFF is consistent with the models of institutional transitions (Peng, 2003; Peng and Ruban, 2003). In market economies, the complex of legal, financial and regulatory institutions is relatively well developed, and as a result the assumptions of Porter’s FFF may be reasonably close to reality. In these economies, FFF may be applicable, since its boundary conditions are reasonably well satisfied. However, in emerging economies, institutions are still in formation, and this calls into serious question the validity of key assumptions underpinning FFF. To the extent these conditions are not met, the model increasingly loses its relevance for strategic action. When the assumptions are severely violated, the FFF may have limited relevance and we may require a theory of political contests rather than economic competition. When the qualifiers deviate somewhat from the assumptions of the FFF, other theoretical models may offer better interpretive and predictive capability, and concomitantly different strategic approaches may be required for effective action.

Specifically, in emerging markets, the underdevelopment of institutional frameworks leads to higher levels of uncertainty in bargaining exchanges between customers and suppliers and in rivalry, and more viscous capital flows than in developed economies. This would lead us to suggest that factors other than those identified in FFF may better predict firm performance. Some empirical evidence from emerging economies tends to support this suggestion. For example, Peng and Luo (2000) demonstrated that in the Chinese sample they studied, traditional strategy variables contributed substantially to performance, although personal ties also exerted significant explanatory power. More recently, Makhija (2003) provided strong evidence to our suggestion in the case of recently privatized firms in Czech Republic. Building on Grant’s (1991b) insight, Makhija demonstrated that in the immediate aftermath of Czech privatization, due perhaps to the high market volatility – a condition correlated with the uncertainty induced by the underdevelopment of institutions, the resource based view (RBV) had greater power in explaining firm performance than the market based view.

The theoretical consequences of these boundary conditions suggest at least four thrusts in empirical research, each of which advances distinct issues in the extant literature.

First, the three qualifiers that emanated from our study of FFF offer a systematic empirical approach to capture the diversity of emerging economies in a theoretically meaningful way. As researchers have emphasized (Hoskisson et al., 2000), emerging economies are themselves diverse, and this diversity has to date been captured as country differences, partly due to the problems of data availability. However, as more researchers focus on emerging economies, attention to qualifiers affords opportunities for typologies and taxonomies. Such classifications are possible in large part because qualifiers enable researchers to chart in a theoretically meaningful manner the institutional evolution in different emerging economies.
Second, the three qualifiers enable researchers to link theoretically firms’ micro strategies to macro institutional contexts. Our analysis suggests both a direct and a moderating effect of qualifiers on firm performance. Since institutional context affects transaction costs and terms of rivalry, and hence the uncertainty associated with it, it has a direct influence on performance of firms and its determinative role in capital flows suggests that the context has a direct influence on growth as well. However, since our analysis suggests that Porter type strategies would need to be augmented with other strategies, the institutional context can be expected to moderate the influence of strategies on firm effectiveness. Indeed Peng and Luo’s (2000) findings provide some empirical evidence for this suggestion.

Third, since most research in emerging economies has focused on transaction costs or capital flows, the evolving norms of rivalry and their implications for competitive dynamics are not well documented. This is an area that demands considerably more attention, since competition is at the heart of strategic management.

Finally, given the importance of network type strategies in emerging economies, we will need research that unearths the effectiveness of different strategies in different economies relative to Porter type strategies.

IMPLICATIONS FOR STRATEGY IN EMERGING ECONOMIES

In our Toulmin analysis of Porter’s FFF, we have reviewed the mounting evidence that firms in emerging economies undertake strategic actions to address the key uncertainties pertaining to exchange, capital availability and unrestricted rivalry, and concluded that many of these actions are not derivable from Porter’s FFF. Since these uncertainties emanate from the institutional underdevelopment characteristics of emerging economies, they are exogenous to FFF. The exogeneity of the qualifiers is a theoretical artifact of Porter’s framework. From the vantage point of strategic actors, however, environmental uncertainties require managerial attention (Thompson, 1967); therefore, the three qualifiers should be viewed as domains inviting action by incumbent firms. Put another way, our Toulmin analysis points up the need to manage strategically the key uncertainties represented by the qualifiers of Porter’s FFF during the protracted institutional transition characteristic of emerging economies.

In the short run, the individual firms may have little influence on the institutional contexts that drive the qualifiers, which are exogenous to Porter’s framework. Consequently, firms may have to augment the strategies flowing from Porter’s analysis with actions designed to ensure the underpinning qualifiers within the existing institutional contexts. Since emerging economies rely on informal rules (North, 1990) and personal relationships among socio-political networks (Peng, 2003), in the short run, network-type strategies oriented toward establishing ties with firms or individuals, or developing and accessing prevailing networks may be an effective, and perhaps the only way, for firms to manage the uncertainties of transaction
costs and rivalry and the viscosity of capital flows. Specific managerial action may consist of establishing: personal ties, inter-firm linkages including strategic alliances (of various kinds) with foreign partners, and links with government. These networks may compensate for the institutional underdevelopment in emerging economies to reduce the uncertainties in transaction costs and rivalry, and the viscosity of capital flows.

This need for managing the qualifiers of FFF may explain the mounting empirical evidence on the pervasiveness of network-type strategies in emerging economies. Alliances for one have been shown to be one response to weak institutional supports (White, 2000). Khanna and Palepu (2000) demonstrated the need for strategists in emerging economies to utilize personal ties to reduce the search costs created by the ‘institutional voids’. Similarly, Nelson (1990) in his discussion of the ‘kept woman strategy’ emphasized its most important assets: ‘extensive and intimate contacts with the national government’. Peng and Luo (2000) underscored the importance of managerial ties, demonstrating further that establishing these ties may be far more important for smaller firms than for larger firms. Most recently, Makhija (2003) empirically demonstrated that in Czech Republic, a firm’s institutional networks and administrative heritage – crucial components of a firm’s ‘competitive capability’ – are significantly related to its performance.

A network strategy may also be important for developed market firms contemplating entry into emerging economies. Inter-firm linkages reduce search costs, providing developed market firms local market knowledge and access (Hitt et al., 2000). Doh (2000) demonstrated how MCI and Sprint used local partner collaboration in their attempts to penetrate telecommunications market in Brazil. Indeed, brown field entry (Meyer and Estrin, 2001) by Western firms into emerging economies – a mechanism devised to manage transaction costs – is intended to gain access to networks through acquisition, not the production capacity of the acquired emerging economy firm. Similarly, Henisz (2000) concluded that partnering with host country firms that ‘possess a comparative advantage in interactions with the host-country governments’ (p. 362) can safeguard against the hazard of opportunistic appropriation by host governments. Isobe et al. (2000) even advised aspiring foreign entrants to China to demonstrate the importance of their investment to the local community in order to develop strong personal connections (or guanxi) in China.

Firms also employ networks to manage uncertainties of competitive rivalry, stressing cooperation (Stark, 1996) through such mechanisms as cross-ownership (Kogut et al., 1992). Alternately, they can use the socio-political networks between firms’ managers and government agencies to thwart existing or new competitors, as illustrated by Doh (2000) in the case of Telmex consortium in Mexico. Finally, the acquisition of capital and resources is likely to be a serious challenge, although this may be true more for emerging economy firms (than for firms from developed economies). They may thus need to establish linkages with foreign firms, offering
their own network position in exchange for scarce capital and resources like technology. In the absence of well developed capital markets, the networks of management internal to a firm may be able to allocate financial resources across industries, and this may explain the formation of groups and diversification in emerging economies (Khanna and Palepu, 2000).

In the long run, since the institutional contexts are in flux, some firms may also be able to influence directly the trajectory of institutional transition shaping the underlying qualifiers. The promise of large markets in many emerging economies is not going to materialize by focusing exclusively on short run strategies. In the long run, as we have noted, the institutions that reduce transaction costs, facilitate easier access to capital, and enforce laws governing rivalry are essential. Although firms are not the only players with a stake in institution development, some of them can and will participate in this activity, shaping it to their interests. Put another way, in the long run the qualifiers in Porter’s framework can be influenced by the actions of some firms, even though the FFF is not adequate for this task.

From our enumeration of the mechanisms by which firms cope with the relative absence of formal institutions in emerging economies, we can project the behaviour of differing firms in this institutional development. Institution development, which by definition alters the rules of the game and consequently industry structures, will create winners and losers, and hence invite political contests. For example, intellectual property laws are likely to be encouraged by some developed economy firms but resisted by the local players who would be thwarted of the potential to imitate. The local incumbents benefiting from their membership in existing networks (especially their relationships with government institutions) are likely to resist development of formal institutions that impose laws governing rivalry, especially if that invites new entrants. Similarly, some developed economy firms partnering with entrenched incumbents may also find the institutional changes detrimental to their situation. Finally, development of capital markets should reduce the focus on diversification in many emerging economies; however, the efficiencies from the restructuring of conglomerates (of the kind we witnessed in the USA) are likely to be opposed by some entrenched managements (see Filatotchev et al., 2000 for an illustration of the influence of managerial entrenchment, in their case of downsizing in Russia, Ukraine and Belarus). A key implication is that institutional transitions are likely to be protracted, and can be viewed as a series of contests, the outcome of which depends on the political resources of rival factions.

We can also outline the general strategies that different players may choose in order to participate in institution development. Developed economy firms may not have a compelling strategic interest in investing their limited resources in this activity, partly because of the free-rider problem. Yet some of them do have the requisite organizational and cognitive know-how and capability for the design and operation of institutions. Hence their role in the long run becomes catalytic, either
influencing global institutions that interact with the elites in emerging economies or by serving in an advisory capacity to the power elites of emerging economies. In the long run, some firms in emerging economies may have a strategic interest in participating in the development of institutions that enlarge the pool of finances and reduce transaction costs. This is an active role (unlike the catalytic role for firms in the developed economies) that may involve the setting up of advocacy groups, developing position papers and directly influencing the corridors of power.

THE NEED FOR FURTHER EPISTEMOLOGICALLY BASED WORK

In summary, a key outcome of the deconstruction of Porter’s FFF through Toulmin analysis has been to unravel the lack of validity of its institutional level assumptions in emerging economies. This has three substantive implications for theory and research in the case of emerging economies.

First, it invites researchers to explore familiar strategic concepts in a new theoretical light and emerging economies offer contexts where such exploration can effectively take place. This invitation is contingent on appreciating how the institutional realities on the ground vitiate the assumptions of the received model and on the resultant responsibility to develop knowledge (warrants, backing and qualifiers) that does not violate these empirical realities.

Second, on a more mundane level, it alerts strategy researchers to be cognizant of the ‘macroenvironmental’ (Narayanan and Fahey, 2001) forces that continually recalibrate the qualifiers for firm-focused theories. In turn this invites an ongoing collaborative dialogue between theorists of the firm and other scholars (e.g. macroeconomists) who focus on different levels of analysis.

Finally, Toulmin’s method offers the strategy discipline the means to develop a continuing interaction between theory and data. Porter’s FFF can be used to develop a frame that hypothetically could be applicable in an emerging economies context; empirical challenges through the medium of qualifiers enable us to revise the conditions under which the frame would apply. Put another way, it offers a methodological bridge to connect theories developed in advanced economies to the empirical realities of emerging economies.

NOTES

[1] North (1990) considers production costs to be the sum of transformation and transaction costs. To avoid confusion, we will use the term transformation costs in this paper to connote production costs exclusive of transaction costs.

[2] ‘A kept woman’ refers to a stand-alone organization or one owned by a strong local entity, whose most important assets are extensive and intimate contacts with the national government (Nelson, 1990). The political contacts of the kept woman are used to obtain information, thereby reducing search costs and to guarantee the flow of government money to the coffers of the kept woman.
REFERENCES


© Blackwell Publishing Ltd 2005


