The Routledge Companion to Non-Market Strategy

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An institutional perspective on non-market strategies for a world in flux

Publication details
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Published online on: 29 Apr 2015

Accessed on: 07 Dec 2018

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The rationale behind firms' non-market strategies is that the political, legal, social, and cultural context can affect firms' ability to succeed in the market place. In this chapter, we reconcile evidence from the economics and finance literature with ideas from the neo-institutional and corporate political activity (CPA) literature to examine relationships between firms' connections, non-market strategies, and outcomes during periods of institutional change. These approaches provide complementary points of view regarding the ways in which institutions shape firms and their non-market strategies. Importantly, these diverse bodies of literature also provide insight into how firms' non-market strategies shape the institutional context for firm advantage. To highlight the interplay between non-market strategy and institutions, we focus on what happens, what works, and what questions are raised when institutions are in flux.

To some degree, institutions are always changing, driven, in part, by the non-market strategies of firms. During periods of intense institutional transition, such as abrupt regime change, the relationships between institutions, firms, and non-market strategies become particularly salient (Peng, 2003). When the tide turns and institutions change, insiders can become outsiders and connections can become liabilities. Advantages gained from years of relationship- and legitimacy-building can disappear altogether (Siegel, 2007). When the institutional context shifts, the value of firms' non-market connections changes and the appropriateness and effectiveness of firms' non-market strategies also changes. This then raises the question of how firms might build successful non-market strategies that are robust to, or even thrive on, institutional change.

To think about how non-market strategies can cope with constant change, one must first understand the effect of institutional change on a firm's position and connections within a given institutional context. Accordingly, this chapter begins with a brief discussion of the ways in which firms are nested within, constrained by, and act upon institutions. We then dive more deeply into the links between social and political connections; firms' political activities and strategies; and institutions. Finally, we discuss the ways in which political connections and corporate political activity interact during periods of institutional change. We examine this relationship in three increasingly uncertain contexts: during institutional change that does not threaten the established institutional order; during institutional change that does threaten the
Feinberg, Hill, and Darendeli established institutional order (e.g., sweeping market reforms such as trade and capital market liberalization); and during periods of intense political and institutional volatility.

The examination of routine institutional change in stable institutional environments draws attention to the underlying mechanisms linking firms to institutions, and through which non-market strategies must act. Similarly, the focus on institutional change that threatens to change an established order underscores the self-reinforcing nature of institutional arrangements, and consequently the resistance to change that is commonly observed. In environments characterized by intense institutional volatility, firm survival often requires developing sensitivity to the subtlest signals and developing the ability to adjust rapidly, even while trying to influence the evolving institutional context. At the extreme, the challenge of coping with abrupt regime change highlights the importance of hedging beyond the formal institutional realm, often by building connections with sources of power and influence located in the social sector.

The institutional context of firm action

There is broad agreement that firms are nested within political, legal, social, and cultural institutions and that these institutions shape firm strategy (Peng, Wang, and Jiang, 2008). However, there is no single theory or literature stream that explores this phenomenon. Just within the management literature, there are at least three approaches to these questions (Doh, Lawton, and Rajwani, 2012). The first approach concentrates on the effect of institutions on firms and vice versa; the second approach explores the mechanisms through which institutions constrain firms; and the third emphasizes comparisons between institutional systems and their effects on firms and firm strategies. Within the economics and finance traditions, different data, methods, and underlying theoretical paradigms are used to raise similar questions about the impact of institutions on firms, the ways in which firms can affect institutions, and variation in firm behavior across institutional contexts. Part of our goal is to reconcile these disparate literatures with their often complementary insights.

Figure 3.1 summarizes the realm in which non-market strategies operate and illustrates the nesting of firms and non-governmental organizations (NGOs) within institutional frameworks. Most importantly, it highlights the role of bi-directional connections (the vertical lines) between

![Figure 3.1 The bi-directional connections between institutions and organizations](image-url)
Institutional perspective

Institutions shape organizations. In this section, we discuss in general terms how institutions shape organizations and vice versa.

**Institutions shape organizations**

Drawing in part on North’s (1990) work on the nature, structure, and evolution of national institutions, scholars in economics and finance ask questions about economic growth and efficiency, and how these are affected by different types of institutions and levels of institutional development (e.g., Levine, 1997; Morck, Stangeland, and Yeung, 1998; Rajan and Zingales, 1998). By looking at how different institutional arrangements affect the behavior of firms, scholars can gain insight into why some economies grow more robustly than others. For example, Rajan and Zingales (1998) find that industries that rely more heavily on external finance grow relatively faster in countries that have well-developed financial market institutions than they do in countries that start with comparatively weak financial market institutions. Demirgüç-Kunt and Maksimovic (1996) find that firms with access to more developed stock markets to raise funds grow at faster rates than those without access to these markets. Interestingly, firms with weak home-market institutions may be able to escape this constraint if they can access better-quality institutions in foreign markets. In general, the effects of institutional context on firm choices and firm performance are especially pronounced in emerging markets because of the potential for institutional volatility (Makino, Isobe, and Chan, 2004).

The management literature has a similar, if smaller, stream of research into the relationship between national institutions and firm choices and performance. For example, Hillman and Keim (1995) argue that the focus of corporate political activity will tend to shift from executive to legislative branch depending upon whether a democracy is corporatist or pluralist. In a similar vein, Bonardi, Holburn, and Vanden Bergh (2006) show that the structure of a firm’s regulatory context, the political rivalries that emanate from that context, and a firm’s ability to cope with the context and rivalries together determine the effectiveness of its non-market strategy.

Recent new institutionalism literature focuses on how institutions shape firms’ perspectives, actions, and outcomes. According to this literature, firms achieve legitimacy by fitting into the formal and informal rules, norms, and cognitive categories that comprise institutional logics (Scott, 2008). Institutional logics shape the interests, identities, assumptions, and attention of individual executives and organizations (Thornton, 2004). In turn, executives and organizations that take actions consistent with the prevailing institutional logics achieve legitimacy in the market place (Biggart and Guillén, 1999). This results in clusters of firms that look and act the same. Kogut, Walker, and Anand (2002: 175) argue that observed international coherence in firm (diversification) strategy is “the etching on a space of technical possibilities left by the confluence of actors and institutions.”

What is generally missing from this literature is detailed work on the mechanisms through which formal and informal political, social, and cultural forces shape business arrangements and conceptual frameworks (Aldrich and Fiol, 1994), which in turn enable and constrain market and non-market strategies (Peng et al., 2008). An emerging stream of literature focuses on the agency of actors embedded within institutions and the role of these actors in driving institutional change (Greenwood and Suddaby, 2006; Hirsch and Lounsbury, 1997). Through the development of new policies, organizational forms, and institutional logics, actors embedded within institutions can bring about institutional change (Patriotta, Gond, and Schultz, 2011; Thornton, Ocasio, and Lounsbury, 2012). For example, Lounsbury (2007) examines how competition between two traditions of practice and their supporting logics...
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drove the evolution of structures in the US mutual funds industry. Another driver of institutional change is friction between institutions. Such frictions can result from the actions of non-business stakeholder groups that challenge existing arrangements and contribute to the building of new ones (Zhang and Luo, 2013). One example is the role of student environmental action committees in the evolution of recycling on college campuses, and of the recycling industry more generally (Lounsbury, 2001).

Organizations shape institutions

A great deal of research in both the management and economics fields has explored how firms strive to improve their performance by positioning themselves within the broader institutional context and by shaping that context when they can. A well-established stream in the international business literature shows that firms can — and do — improve their performance by scanning, anticipating, and influencing the political environment in host countries (Alon, Gurumoorthy, Mitchell, and Steen, 2006; Boddewyn and Brewer, 1994; Eden and Lenway, 2001; Oliver and Holzinger, 2008). In so doing, global firms conform to rules, norms, and belief systems of the actors in a host country. But they also actively engage in manipulating practice and symbols to try to affect both perceptions of what is legitimate and their fit within those perceptions (Bitektine, 2011; Kostova, Roth, and Dacin, 2008).

For example, Dahan, Doh, and Guay (2006) describe how firms work in concert with others in policy networks to create a predictable institutional context in which to operate. Vasudeva, Zaheer, and Hernandez (2013) argue that firms use their boundary-spanning scope both to derive advantage from variation in institutional arrangements and to try to shape institutional arrangements to their liking. An analogous example in the economics and finance literature is the use of cross-listing by emerging market firms as a form of institutional “rental” (Siegel, 2007). Siegel (2005) argues that because many emerging-market firms come from weak institutional environments, they have difficulty signaling their quality, which prevents them from accessing cheap external resources. By cross-listing and adhering to strict developed-market reporting requirements, firms span national boundaries to “borrow” developed institutions and credibly enhance their global reputation (Siegel, 2009).

The pervasive role of connections

A fundamental assumption underlying research on the relationship between institutions and firms is that both can form and leverage “boundary-spanning personal and institutional linkages between firms and the constituent parts of public authorities” (Sun, Mellahi, and Wright, 2012: 68). Such connections carry symbolic and material advantages (Delmas and Montes-Sancho, 2010; Thornton and Ocasio, 2008). Connections intermediate firms’ interactions with all institutions, and in the following sections we discuss the links between connections, firms’ non-market strategies, and institutions. We then discuss the effect of institutional change on the value of firms’ connections.

Connections and non-market strategy

To gain a better understanding of the ways in which institutions interact with firms’ non-market strategies, we distinguish between the ways in which firms are connected and why; the implications of these connections for the types of non-market strategies firms can successfully pursue; and the kinds of benefits firms can gain from their non-market strategies.
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We begin by describing the links between connections and non-market strategy, as informed by two related but distinct streams of literature – the management literature on corporate political activity (CPA); and the economics/finance literature on political connections. We focus specifically on firms’ political connections with the implicit assumption that these connections can bring firms direct financial advantage and can facilitate advantageous institutional change.

Firms’ political connections arise from three main sources. First, connections between managers and politicians can arise from “exogenous” sources, such as attending similar schools (Bertrand, Kramarz, Schoar, and Thesmar, 2006; Cohen, Frazzini, and Malloy, 2010); family relationships (Morck et al., 1998); party membership (Li, Meng, Wang, and Zhou, 2008); business group ties (e.g., Khanna and Palepu, 2000); and geographic ties to politicians (Faccio and Parsley, 2009). Johnson and Mitton (2003: 353) provide a great example from a study of Malaysian political economy:

the connection of firms to individual politicians appears to have been based primarily on chance personal histories. Early friendships with rising politicians, such as Mahathir and Anwar, have been an effective way to build firms in Malaysia over the past 20 years. In other words, the personal relationships between individuals in our dataset largely predate associations of these individuals with particular firms and so political connections were not determined by the nature of the firms themselves.

Second, connections can be formed as a natural result of what businesses do. For example, heavily regulated firms and firms that work as government contractors develop ongoing associations with government actors at a variety of different levels (e.g., Birnbaum, 1985).

Third, political connections arise endogenously as part of a firm’s corporate political strategy. This can involve hiring former politicians or including them on corporate boards (Lester, Hillman, Zardkoohi, and Cannella, 2008); placing firm executives in political positions (Goldman, Rocholl, and So, 2009; Hillman, Zardkoohi, and Bierman, 1999); and making campaign contributions, PAC contributions (donations to “political action committees” that bundle donations and, in turn, donate to candidates or campaigns), or other monetary gifts (Cooper, Gulen, and Ovtchinnikov, 2010; Stratmann, 1991).

Some scholars have tried to link firms’ political strategies with their political connections. For example, Hillman and Hitt (1999) make the distinction between relational and transactional approaches to political strategy. The relational approach to political strategy has to do with the “development of social capital that is embedded in a continued exchange relationship between parties” (Hillman and Hitt, 1999: 829). When firms use a relational approach to political strategy, they develop and maintain close links to important connections as a matter of priority. In contrast, the transactional approach to political strategy is more issue-driven and involves developing and communicating with connections on an as-needed basis. Conceptually, however, the distinction is hard to maintain, since firms no doubt use their “relational” position with connections to lobby for particular “transactional” favors, such as preferred policies, subsidies, and so on, while firms that engage in repeated “transactional” approaches will likely develop “relational” interactions with those political actors with whom they have often engaged on issues. To us, this conundrum highlights the complex links between political strategy and political connections: political strategies are embedded in relationships, even as relationships facilitate strategies.

In general, the management literature has tended to focus more on the question of what firms do with their connections, while the economics and finance literature has tended to focus more on the connections themselves and the value firms derive from those connections
in a variety of contexts. Combining the economics and finance literature’s emphasis on the ties themselves and the strategy literature’s emphasis on the intentional formation and manipulation of ties suggests a more complex relationship between firms’ political connections, political strategies, and outcomes than is implied in either literature alone. Figure 3.2 shows a stylized set of relationships between firms’ connections, the implications of these connections for political strategies, and the kinds of outcomes firms can gain from their political strategies.

The dense web of relational and structural ties that exist prior to the formation of any given political strategy are critical to the kinds of political strategies firms devise. Conversely, firms’ political strategies may necessitate the development of new connections to politicians at various levels of government. “Since political institutions are among the most difficult environmental dependencies to control, firms may seek to co-opt political stakeholders by developing personal and organizational linkages so that potentially hostile elements of environmental uncertainties can be neutralized” (Sun et al., 2012: 70–1). In this way, strategy also influences political connections.

Firms’ connections can lead to direct outcomes, such as trade or capital market restrictions (Morck et al., 1998). Similarly, outcomes have a feedback loop to connections, implying that firms may need to “compensate” connections in some fashion for bestowing them with favors (e.g., Nee, 1989). Positive or negative outcomes provide feedback to firms with regard to the value of their connections. Firms may react to disappointing outcomes by developing different connections or trying to reform or redirect existing connections. Outcomes also have a bi-directional relationship with firm strategy, suggesting that strategies may be reinforced or reconsidered in light of their ability to generate positive outcomes.

Finally, changes in the value of these connections affects the outcomes firms receive as well as their political strategies and tactics. In the next section, we discuss these relationships further in the context of different types of institutional change.

**Institutional change, connections, and political strategy**

There are two primary mechanisms through which changes in institutions affect firms’ non-market strategies. First, institutional changes can affect the *value of firms’ political connections*. For example, when politicians, regimes, or parties to whom firms are closely connected change, these connections often lose their ability to extract benefits for firms (Fisman, 2001; Johnson
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and Mitton, 2003). At the extreme, political connections can become liabilities when a new government comes into power (Leuz and Oberholzer-Gee, 2006; Siegel, 2007).

Institutional change can also affect firms’ political strategies by limiting the ability of connections to distribute benefits to favored firms. For instance, when countries experience severe economic shocks, the ability of policy-makers to provide direct subsidies to firms is severely curtailed. Johnson and Mitton (2003) and Leuz and Oberholzer-Gee (2006) find that at the initial onset of the Asian economic crisis, the most politically connected firms suffered disproportionately relative to less connected firms. These results suggest that the crisis reduced the expected value of government subsidies to politically connected firms. In a similar vein, Morck et al. (1998) posit that trade liberalization and capital market liberalization can help level the playing field between entrenched family-controlled firms, entrepreneur-controlled firms, and widely held firms.

At the most general level, these mechanisms imply that when institutional change affects the value of a firm’s political connections, then the firm’s strategy should adjust either to foster new and more productive connections or to forgo connections entirely. Being so responsive requires active monitoring and management of a firm’s myriad ties. In this regard, Sun et al. (2012) begin to specify the non-market factors that affect the value and usefulness of a firm’s connections, including the portfolio of ties maintained, the nature of the ties themselves (e.g., ownership versus non-controlling), the political or social fortunes of the counterparty, and the bargaining-power balance between the firm and its counterparties. In addition, we suggest that the speed and size of the institutional changes at hand will prove critical. A political strategy that works well to cope with routine policy change in an orderly and stable institutional environment might not work so well if the institutional environment itself is shifting (as in liberalization). Even more challenging is designing and implementing a political strategy that is effective during periods of extreme institutional volatility, or, worse, regime change. In the following sub-sections, we consider the role and value of connections – and the implications for strategy – of policy change in a stable institutional environment, when there are gradual shifts in the institutional context, and when institutional volatility reigns.

The role and value of connections during political change that does not threaten the institutional order

A large and robust literature finds that, in stable institutional environments with orderly changes in power, the value of politically connected firms is significantly enhanced by favorable political outcomes. In general, the finance and economics literature has shown that connected firms are given superior access to finance (Claessens, Feijen, and Laeven, 2008; Morck et al., 1998), favoritism with regard to government contracts (Amore and Bennedsen, 2013; Goldman, Rocholl, and So, 2013), and favorable regulatory and other policies (Morck et al., 1998). In a cross-country study, Faccio (2006) finds substantial increases in firm value when large shareholders or officers of firms enter politics, and when politicians to whom firms are connected are appointed as ministers or elected to parliament. Knight (2006) found significant positive returns to firms associated with either Bush or Gore in reaction to news that the candidate to whom they were connected had a higher probability of winning the presidential election. In a similar vein, Goldman et al. (2009) found the value of firms connected to the Republican Party increased after Bush won the 2000 presidential election.

In fascinating recent research, Braggion and Moore (2013) document that in Victorian Britain firms with board members elected or reelected to the House of Commons experienced a significant increase in value. However, the benefits were not the same for all
connected firms. The authors find that only “new-tech” firms – that is, younger firms associated with the second Industrial Revolution – experienced significant increases in value, while established “old-tech” firms experienced no impact. The authors attribute this result to the fact that new-tech firms needed connections to gain legitimacy and, more importantly, access to financial resources.

The use of connections as a means to confer legitimacy and access to capital still operates today, as Powell, White, Koput, and Owen-Smith (2005) describe in their study of the dynamics of the establishment of biotechnology as a recognizable, network-based industry. Such research showing that connections have a differential effect on new-tech and old-tech firms points to a need for research to open up the black box of the association between connections and firm value. For example, Khwaja and Mian (2005: 1373) use a very detailed dataset on loans made to firms, electoral data, and information on firms’ political connections to shed some light on the mechanisms underlying their findings that politically connected firms receive greater preferential treatment from government banks when either the politicians or the political parties to which the firms are connected win an election.

These results offer a particular mechanism of political rent seeking consistent with the institutional environment of Pakistan’s banking and political system. Politically powerful firms obtain rents from government banks by exercising their political influence on bank employees. The more powerful and successful a politician is, the greater is his ability to influence government banks. This influence stems from the organizational design of government banks that enables politicians to threaten bank officers with transfers and removals, or reward them with appointments and promotions.

Similarly, Hillman et al. (1999) find significant increases in firm value stemming from personal service in elected or appointed policy positions by managers or board members of firms. However, they acknowledge the problems inherent in uncovering underlying mechanisms: “Given [the use of event study] methodology, we cannot determine what underlies the change in performance, whether it be reduced uncertainty, reduced transaction/information costs, increased legitimacy or prestige, etc., and we cannot generalize beyond these sample appointments” (Hillman et al., 1999: 79). We view the potential to uncover these underlying mechanisms as one of the most important avenues for future research.

One promising approach to teasing out the underlying mechanisms would be the use of social network analysis to map the pattern of political and social ties that connect political and corporate actors and then to trace the flow of information and resources through those ties. For example, Jäger (2013) finds that French and German executives’ relative centrality in social and political networks is strongly associated with their motivation and ability to support the introduction of the euro, while Mahon, Heugens, and Lamertz (2004) show how network density and centrality affect the management of issues and coalitions. The tracing of informational and resource flows through various kinds of networks would contribute significantly to our understanding of how political and social connections affect both firm performance and institutional arrangements.

**The role and value of connections during political change that threatens the institutional order**

Policies aimed at liberalizing trade, capital markets, and other components of the institutional environment pose great threats to connected firms in that they level the playing field for
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non-connected firms (Morck et al., 1998; Siegel, 2007). The degree and scope of liberalization matters because superficial cosmetic liberalization can actually increase the favoritism granted to connected firms (Siegel, 2007). However, real liberalization can negatively affect connected firms in two ways. First, if liberalization includes appointing technocrats to positions once held by politicians or cronies, then the policy change will directly affect the value of firms’ political connections by removing them from various branches of government. Second, even if no personnel or organizational changes are made, liberalization should affect the ability of firms’ connections to grant favors. For example, increased transparency and rule of law makes it more difficult to divert government contracts to favored (but less efficient) firms. Similarly, greater transparency limits the ability of politicians to give connected firms direct subsidies and preferential access to finance (Gelos and Werner, 2002). In contrast, when more cosmetic liberalization occurs but institutional uncertainties, weak property rights, and/or inadequate rule of law persist, the value of firms’ connections may not change at all, or could even increase (e.g., Bian and Logan, 1996; Luo and Chung, 2005; Park and Luo, 2001). In such situations, the failure to enact meaningful policy and institutional change means that politicians and cronies to whom firms are connected retain their ability to channel benefits to connected firms.

Liberalization, or any thoroughgoing institutional change, is often contested precisely because the stakes are high for politicians and executives alike. During periods of institutional change, connected firms and politicians can be expected to defend the status quo. For example, Morck, Wolfenzon, and Yeung (2005: 657) argue that, because connected firms often receive preferential access to finance in countries with weak financial market institutions and a lack of transparency (Claessens et al., 2008; Faccio et al., 2006; Morck et al., 1998), these firms have a particular interest in hindering the liberalization of capital markets: “to preserve their privileged positions under the status quo . . . elites might invest in political connections to stymie the institutional development of capital markets and to erect a variety of entry barriers.”

Well-connected elites are likely to fight liberalization because preferential access to finance affects the financial and operating strategies of connected firms. For example, politically connected firms tend to be much more leveraged than non-connected firms (Faccio, 2006) and are less likely to raise money on foreign financial markets, despite their larger size (Leuz and Oberholzer-Gee, 2006). If connected firms benefit from cheap and easy access to capital in the home market, taking on more debt involves less risk of bankruptcy, especially since politically connected firms are also more likely to be bailed out when experiencing financial distress (Faccio et al., 2006). Similarly, there is no need for connected firms to incur the added costs and more stringent reporting standards required in countries with more developed financial markets if they have ample access to cheap financing at home. Indeed, Chaney, Faccio, and Parsley (2011) find that connected companies disclose lower-quality accounting information than non-connected firms. In well-functioning capital markets, firms that disclose lower-quality accounting information face a higher cost of capital, but connected firms are not penalized in this way. For all these reasons, connected firms become dependent upon their connections to continue to maintain favorable policies, and they support their connections with gifts, donations, and bribes (Guthrie, 1998), channeling resources to corrupt politicians and strengthening their grip on power.

Using the example of capital market institutions, Figure 3.3 sketches these interactions and illustrates self-reinforcing mechanisms that provide an explanation for why and how institutional arrangements tend to persist, and why they are so difficult to change. This cycle of influence suggests that institutions are in many ways generated endogenously by interactions between the players that shape institutions.
In environments with weak institutions and rule of law, investments in political connections are particularly valuable (Park and Luo, 2001). The use of these connections, in itself, is likely to weaken the institutional environment further and discourage transparency. Connected firms will pursue policies that bring net benefits, such as trade protection and capital market restrictions, and the existence of these policies will affect firms’ operations. In the case of capital market restrictions, connected firms can receive preferential access to finance which enables them to rely exclusively on the domestic market for financing (Faccio, 2010). Restricted domestic capital markets reduce firm growth and discourage transparency (Morck et al., 1998), further weakening institutional development. And so the circle turns, and the system of power relationships reinforces itself (see also Djelic, Nooteboom, and Whitley, 2005).

Not surprisingly, such a system is likely to resist change imposed from the outside, often by using political and legal means (Schuler, Rehbein, and Cramer, 2002). For example, Feinberg, Magelssen, and Smith (2014) document an interesting example of widespread resistance to liberalization that took place in India in the context of an IMF bailout in 1991. As part of the bailout, the International Monetary Fund (IMF) required India to lower its import tariffs dramatically from an average of 85 percent (Bown and Tovar, 2011). Facing a strict deadline and wanting to avoid the emergence of political opposition (Topalova, 2008), the Indian government chose to implement reform rapidly. By 1997, tariffs had fallen to an average of 25 percent, significantly increasing the competition faced by inefficient domestic firms. Rather than submit quietly to these changes, leading politically connected firms set off a wave of antidumping complaints in an effort to roll back the tariff reform.

Despite such opposition, institutional arrangements do change, sometimes radically, and during periods of change these same reinforcing mechanisms may, at some point, accelerate rather than resist such change. Thus, in the context of Chinese agricultural reforms, Nee (1989) hypothesizes that as market exchange replaces the redistributive mechanisms in state socialism, political capital will lose value relative to market capital. Nee finds several fascinating effects of “real” agricultural liberalization. First, the transition from redistributive to market coordination shifts sources of power and privilege to producers relative to redistributors. Second, this shift stimulates the growth of private markets. Third, as markets grow, incentives and opportunity structures change, giving entrepreneurs a path to prosperity and social mobility. Fourth, the rapid economic growth in China placated the elites. Although their relative power declined due to the loss in value of their connections, “the greater affluence produced by markets reinforce[d] the sense that the benefits of economic reform [were]
widely distributed” (Nee, 1989: 678). Finally, by 1998, market reform had combined with economic growth to reduce the value of firms’ political connections in China, leading firms to substitute legal mechanisms for *guanxi* practice – the reliance on connections (or *guanxi*) to “carry out procedures and go around the law” (Guthrie, 1998: 254). A Chinese manager interviewed in Guthrie’s study comments:

> When people rely on “guanxi practice” for procedural matters . . . as they did in the past, society becomes very messy . . . In the old system, if you wanted to get procedures done, you had to make sure you knew people in the right places, you had to try getting procedures passed by relying on the people you knew. You had to talk to many people, and the process always took a long time. It wasn’t always certain you would know the right people to get procedures taken care of. But now it’s all very clear. You just follow the laws and make sure that you follow all of them closely. Things happen much more quickly today.

*(Guthrie, 1998: 254)*

As Figure 3.3 and these examples illustrate, institutional arrangements seem to be endogenous and self-reinforcing, in the sense that they are created and maintained by the very firms, politicians, and other interest groups who are embedded in the institutional web. Given this, we suggest that new research should explore the nature and consequences of the various feedback loops between connected firms and their behavior; government actors at different levels and the policies they put in place; and the institutional environment in which these interactions take place.

Furthermore, an analysis of these relationships in the context of institutional change would help shed light on the mechanisms underlying observed relationships between political connections, firm strategy, and outcomes. For example, do firms change their approach to political connections (e.g., relational and transactional) after successful or unsuccessful efforts to influence policy? Do firms reaffirm their commitment to existing connections or redouble their efforts to forge new ones in light of the outcomes of their political activity? What kinds of favors come from different kinds of connections and how does this influence firms’ political strategy? Is there a qualitative difference between the kinds of favors firms can get from connections that arise from chance preexisting relationships versus connections that are cultivated as part of an overall political strategy? What kinds of quid pro quo do firms’ connections demand in return for granting favorable policies? What, if any, effect does the demand for quid pro quo have on firms’ political strategies and their future approach to dealing with connections?

**The role and value of connections in a volatile political and institutional environment**

During periods of intense and sustained volatility, uncertainty about institutional change affects firms’ political strategies by making *political sensitivity and responsiveness* central to company survival. In contexts characterized by institutional voids (Khanna, Palepu, and Sinha, 2005) governments exercise extreme and volatile control over regulation, resources, information, and the license to operate. In management research, the dominant prescription has been for firms in such environments to develop deep personal and organizational relationships with leading governmental figures and entities (Cuervo-Cazurra, 2006; Sun, Mellahi, and Thun, 2010). For example, embedding a firm within the local power structure has been
shown to mitigate various political and contractual risks, to improve learning about the local system, and to improve access to resources, information, and political favors (Frynas, Mellahi, and Pigman, 2006; Peng and Luo, 2000; Peng et al., 2008). Similarly, Peng and collaborators have shown that in difficult and changeable environments, managers still find a way to succeed, often relying on network-based growth strategies (Peng, 1997; Peng and Heath, 1996; Peng and Zhou, 2005). Sometimes, firms can succeed by exploiting their complex family and social connections to politicians to monitor and buffer changes in the institutional environment and firms that are successful in unstable institutional environments may be those that are attuned to every nuance of the political wind (Farashahi and Hafsi, 2009). These firms cultivate deep relations with specific constituencies and interact often and assertively with the government to try to create a more predictable context. Thus, in unstable contexts, executives find themselves in the unfamiliar role of political analysts and diplomats trying to discern which political faction will prevail, which set of rules will dominate, and how to engage politically (Chen, Ding, and Kim, 2010; Getz and Oetzel, 2009; Jallat and Shultz, 2011; Margolis and Walsh, 2003).

Becoming so closely attuned to the political wind demands a tremendous investment in understanding the local political situation and behavioral norms, and then, when possible, building effective means of influence within this context (Bonardi et al., 2006; Frynas et al., 2006; Lawton and Rajwani, 2011). However, the experience of firms and individual managers can reduce the difficulties and costs of managing political and regulatory uncertainty (Bonardi et al., 2006; Henisz and Delios, 2004). Indeed, firms that have grown up in unstable home countries show a greater willingness to enter and a greater ability to survive in similarly uncertain contexts, at least in part because of political sensitivity and adaptability (Cuervo-Cazurra and Genc, 2008; Holburn and Zelner, 2010).

In many instances, the reliance on personal connections to affect government is associated with cronyism and corruption (Bunkanwanicha and Wiwattanakantang, 2009; Johnson and Mitton, 2003; Morck et al., 1998). These conditions may be reinforced by culture (Khatri, Tsang, and Begley, 2006; Mauro, 1995) and the personal interests of powerful families and groups (Fisman, 2001; Morck et al., 1998; Wood and Frynas, 2006). In the context of institutional volatility, relying on political ties heightens the risk of becoming dependent on, and beholden to, political actors within the larger network (Sun et al., 2010), who may arbitrarily increase their demands for support (Kivleniece and Quelin, 2012) or be thrown out of office when the political regime changes.

Indeed, the most significant risk to firms that have invested in political ties in uncertain environments is the potential for the entire political context to shift. In such cases, the value of firms’ political connections can evaporate completely. In the extreme, connections to old regimes can become liabilities when a new government comes into power and attempts to turn the tables on the previous regime (Leuz and Oberholzer-Gee, 2006; Siegel, 2007). Experience in Iran (1977), Central Asia (1991), Indonesia (1998), and during the Arab Spring has shown how quickly countries can shift from stability to chaos as power flows from unexpected sources to upset the established order (Fisman, 2001; Sun et al., 2010).

While firms can sometimes help to resolve even violent conflict (e.g., by facilitating negotiations; Getz and Oetzel, 2009), they run the very real risk that close association with the government will be devastating if their political patrons suffer a setback (Leuz and Oberholzer-Gee, 2006; Siegel, 2007). For example, in the context of a hotly contested Malaysian election after the imposition of capital controls, Johnson and Mitton (2003) find that connections to Mahathir (the winner) accounted for 20 percent of the increase in
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firm value, and connections to Anwar (the loser) were associated with a 6.3 percent decrease in firm value. Similarly, Fisman (2001) provides early evidence that the threat of regime change is particularly damaging to politically connected firms. Examining how share prices of politically connected and non-connected Indonesian firms reacted to rumors of Suharto's ill health, Fisman concludes that political connections are a large source of value for a relatively small group of entrenched and powerful firms. More dramatic still are examples of the complete collapse of firms associated with regimes that are deposed during a revolution (Getz and Oetzel, 2009).

As in all political situations, however, there may be more nuance than meets the eye, even during abrupt regime change. A recent case study of how Turkish multinational construction firms navigated the collapse of the Gaddafi regime (Darendeli and Hill, 2013) suggests that the firms that had developed relations with regionally powerful families outside of Gaddafi's circle and those associated with public-benefit projects, such as universities and hospitals, were protected from looting and allowed to continue their work, even if they had also benefited from close ties with the Gaddafi regime. Investment in connections to non-governmental sources of power and corporate social responsibility (CSR)-type efforts proved to be an effective hedge against the consequences of being associated with an overthrown dictator.

This example points to sources of legitimacy and countervailing power embedded in the social sector as a way to establish and maintain legitimacy, even in the face of extreme institutional volatility (Ramamurti and Doh, 2004). Actors in this sector have successfully pushed for institutional change that affects both business and political interests. For example, “the many codes, standards, and norms developed to encourage industries to adopt better environmental, labor and human rights practices are primarily a result of institutional pressure from social movements and actors” (Doh et al., 2012: 35). Looking outside the political realm broadens the list of influential actors with whom firms can form meaningful connections to include advocacy groups, consumers, labor, nonprofits, and the media (Dacin, Oliver, and Roy, 2007). Further, directing non-market strategies toward civil society actors has been shown to have a positive impact on the success of firms’ overseas operations (Tashman and Marano, 2009; Vachani, Doh, and Teegen, 2009) and to help heal rifts after conflicts (Getz and Oetzel, 2009). Similarly, local non-governmental organizations (NGOs) can provide firms with access to countries, markets, or social strata that might otherwise be unattainable (Boddewyn and Doh, 2011; London and Hart, 2004).

Conclusion

We began this chapter by asking how firms might build successful non-market strategies that are robust to, or even thrive on, change. We tried to craft an answer by examining a diverse literature as it relates to situations in which political change is routine and does not threaten the established institutional order; situations in which political change does indeed threaten the established institutional order; and situations in which both the political and institutional contexts are volatile and uncertain. Throughout, we focused on the role of boundary-spanning interpersonal ties that connect firms to institutions and through which influence and resources flow.

Our exploration of the role and value of connections during change that does not threaten institutional arrangements served to highlight the formation, role, and bi-directionality of flows through connections. The key idea is that connections, strategy, and outcomes reinforce each other – that the formation, maintenance, use, and value of connections comprise
a process that is constantly in motion and in need of continual attention. We suggest that scholars focus further attention on understanding this process and that social network analysis tools could be useful in this regard.

Our exploration of the role and value of connections during change that does threaten institutional arrangements generated a mechanism of self-reinforcing feedback loops that, ironically, helps to explain why institutional arrangements are so resistant to change. This model also suggests that institutional arrangements are largely endogenous in the sense of being created through the interplay of firms and other actors embedded within a given institutional context.

Our exploration of the role and value of connections in a volatile institutional environment focused on potential sources of power and influence outside of the political realm, and we highlighted the role of civil society as a source of legitimacy and countervailing power. There is a growing body of literature that suggests that it would be useful for scholars and managers alike to turn their attention to the active management and deployment of connections in the social sector, perhaps using the social movement literature as a guide.

More philosophically, we hope that this chapter reinforces two points: that connections are central to non-market strategy; and that change is the norm, even in seemingly slow-moving institutional environments. As social beings, we bring our interpersonal ties to everything we do, and contribute to the formation, reinforcement, or dissolution of ties through every interaction. It is perhaps not surprising that such ties are central to non-market strategies, and that they extend not just to the political institutions but to social institutions and indeed throughout markets. It also seems likely to us that personal connections and associated informal institutions will remain important parts of the institutional landscape in varying forms and combinations.

Similarly, while institutions may well be endogenously generated and resistant to change, they do change, and constantly, in response both to exogenous shocks and to the agency of interconnected actors nested within them. Change is the usual state and so requires a more process-oriented approach to research and theory, as well as real engagement in whether the direction of change is somehow positive or negative in its impact on diverse actors. Whether the effect of institutional change is positive or negative has important ramifications for society at large. When institutions encourage efficient and high-quality firms to grow, invest, and innovate, the resultant economic growth can bring widespread benefits.

References


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