JOURNAL OF EAST-WEST BUSINESS
https://doi.org/10.1080/10669868.2019.1708838

Routledge
Taylor & Francis Group

The Impact of Governance Quality on Subsidiaries' Performance: A Survey Analysis from Turkey

Dimitris Manolopoulos[a], Aristides Bitzenis[b], and Ekrem Tatoğlu[c]

[a]Department of Business Administration, Athens University of Economics and Business, Athens, Greece; [b]Department of International and European Studies, University of Macedonia, Thessaloniki, Greece; [c]Department of Management, School of Business, Ibn Haldun University, Başakşehir, Turkey

ABSTRACT

We employ the quality of governance to study the impact of local institutional context on foreign subsidiaries' performance. We propose and empirically document that local institutional quality has growth-enhancing effects on subsidiary growth. More specifically, we show that political stability, government effectiveness, regulatory quality, and rule of low are positively and significantly related to subsidiaries' output. Our findings suggest that, apart from resources and market considerations, institutional constructs should be included as influential predictors in the general models investigating subsidiary performance.

ARTICLE HISTORY
Received 6 September 2019
Accepted 10 December 2019

KEYWORDS
Institutional theory; quality of governance; subsidiary performance; Turkey; WGI indicators

Introduction

Over the last decades, a number of studies have gradually focused on subsidiaries as a distinctive field of investigation within the broad areas of international management strategy, and international business research (e.g. Paterson and Brock 2002; Rugman and Verbeke 2001). Within this literature, the study of foreign subsidiary performance is one of the most fundamental and much-debated issues among scholars, and practitioners alike (e.g. Birkinshaw, Hood, and Young 2005; Kafouros and Aliyev 2016). Traditionally, the majority of the work in the field was mainly anchored either on the premises of the market-based (MBV) (Porter 1980), or resource-based view (RBV) of the firm (Barney 1991; Wernerfelt 1984). According to the former, firm performance depends upon the structural conditions of the industry in which the subsidiary operates, such as the extent of rivalry among competing firms (Christmann, Day, and Yip 1999), the size of the market, and the availability of suppliers (Birkinshaw, Hood, and Young 2005). In an opposite direction, RBV has adopted a firm-

CONTACT Dimitris Manolopoulos dmanolop@aueb.gr Department of Business Administration, Athens University of Economics and Business, 76, Patission Avenue, PC 10474, Athens, Greece
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internal perspective, positing that subsidiary performance is contingent upon the successful exploitation of intangible assets and capabilities in foreign markets, such as technology and innovation, knowledgech, information, intellectual property, technical, and human expertise (Fang et al. 2007; Fey and Bjorkman 2001; Hughes et al. 2017). These resource-based advantages usually stem from the parent organization, with the overall purpose to secure the competitive position of their geographically dispersed subunits (Mellahi et al. 2013). Subsidiaries have access and exploit different types of resources and, therefore, perform differently in their marketplaces (Andersson, Forsgren, and Holm 2001).

Notwithstanding their important insights in explaining performance determinants, MBV overemphasized the importance of industry structure, leaving the inside of the firm to act as a "black box", while the RBV has not looked beyond the properties and characteristics of resources, neglecting in that way the role of external factors in organizational growth (Manolopoulos, Chatzopoulou, and Kottaridi 2018). More importantly, both theories have been criticized for not considering the relative importance of country effects, such as local institutions, in determining subsidiary performance. However, different country conditions and different types of relationships with local institutions influence both industry structure and the way multinational enterprises (MNEs) leverage their resources in international markets (Birkinshaw, Hood, and Young 2005). Thus, the institutional context of a country may act as a catalyst on subsidiary performance (Konara and Shirodkar 2018; Spencer and Gomez 2011).

Grounded upon these developments, institutional perspectives filled the MBV and RBV voids, gaining increasing recognition in explaining MNEs competitive and performance dynamics in the international market space (e.g. Goldszmidt, Brito, and de Vasconcelos 2011; Hughes et al. 2017; Spencer and Gomez 2011). In particular, given that institutions shape "the rules of the game" (North 1990) for a society and its market structure, they play an important role in explaining foreign subsidiary sources of value and growth in foreign environments (Chung and Beamish 2005). Thus, institutional arguments complement MBV and RBV perspectives and have proven to be considerable insightful in unlocking the determinants of foreign subsidiary performance (Christmann et al. 1999; Peng et al. 2009).

Considering the above and building upon the inroads of institutional theory, the purpose of this research is to study the impact of local institutional context on the performance level of MNE foreign subsidiaries. In order to test our research intention, we focus on Turkey, a country where a statist polity environment traditionally exists, in combination with the recent changes toward the establishment of a more liberal socio-economic system (Özen and Akkemik 2012). The core theoretical and practical

implication of our analysis is that host institutional quality is an influential predictor of firm performance, and a majority of its dimensions, i.e. political stability, government effectiveness, regulatory quality, and the rule of law increase subsidiaries' performance. This finding corroborates prior institutional-oriented subsidiary management studies, showing that apart from resources and industry considerations, local institutions may have determinant effects on subsidiary performance. In this regard, we add to research positing the value of an institution-based theory in subsidiary theorizing (e.g. Dikova 2009; Goldszmidt, Brito, and de Vasconcelos 2011; Konara and Shirodkar 2018; Spencer and Gomez 2011). At the second level of analysis, we also contribute to institutional literature by providing perceptual evaluations of governance quality on firm performance; as compared to objective data reported in secondary databases used by most researchers (e.g. Chao and Kumar 2010; Kottaridi, Giakoulas, and Manolopoulos 2019; Ward, Yasar, and Maurisson 2010). Perceptual measures are particularly useful in institutional studies since these constructs are difficult to quantify (Manolopoulos, Chatzopoulou, and Kottaridi 2018). Finally, we present empirical evidence on the relationship between local institutional quality and subsidiary performance from Turkey, a country with a strong global presence in the world economy.

Theoretical background and research questions

The MBV of the firm, derived largely from the patterns of competition in the United States in the 1970s (Peng et al. 2009), originates conceptually from industrial organizational economics, and adopt an industry focus and external market orientation to address value and firm profitability (Caves and Porter 1978). Bain's (1968) structure-conduct-performance (SCP) continuum and Porter's (1980) five forces model are the main MBV theoretical anchors which lay the (micro)foundations of a firm to achieve sustained competitiveness and superior performance. According to these frameworks, firm performance relates to the exploitation of a unique set of activities that are different from its rivals and/or how an organization performs similar activities to other firms, but in very different ways (Makhija 2003). Thus, performance is determined by the structure and competitive dynamics of the industry within which a firm operates (Wang 2014, p. 34). Privileged end-product market positions are the basis for superior performance for specific firms, compared to others that compete within the same industry space (Makhija 2003, pp. 433). Within this perspective, MNE foreign subsidiaries operate in diverse competitive environments, have differentiated market power, and achieve different performance levels (Makhija 2003).

In contrast, the RBV of the firm (Barney 1991; Wernerfelt 1984) shifted from industry to firm-specific effects regarding sources of value, competitive advantage, and performance (Spanos and Lioukas 2001). Its central premise is that firms compete on the basis of their resources and capabilities (Peteraf and Bergen 2003). RBV adopts two core assumptions in analyzing the relationship between sources of competitive advantage and performance (Barney 1991). First, firms within an industry may be heterogeneous with respect to the bundle of resources they possess (Madhok, Li, and Priem 2010). Second, since resources are imperfectly mobile across firms, this resource heterogeneity may persist over time (Helfat and Peteraf 2003). In this vein, a (sustainable) competitive advantage leading to advanced performance levels is provided by valuable, rare, and hard-to-imitate firm-level resources and capabilities that competitors are unable to reproduce (Prahalad and Hamel 1990). Along with the RBV perspective, when competing in international markets, foreign subsidiaries may adopt the MNE well-established resource endowments (e.g. organizational practices) for internal legitimacy (Hughes et al. 2017; Mellahi et al. 2013), or develop new resources and capabilities (Lu and Xu 2006) which will boost their further development (Birkinshaw and Hood 1998), and influence their performance levels (Subramaniam and Watson 2006).

Both the MBV and RBV have introduced insightful considerations on the importance of organizational resources, and market competition structural dynamics in shaping firms' performance outcomes. However, being largely focused on national settings, they have not paid adequate attention to foreign contexts (Peng et al. 2009). In the contemporary business reality, many firms operate in multiple market environments and, nowadays, international business literature has clearly established the relevance of diverse country contextual conditions to performance studies (e.g. Beamish 1985; Dunning 2009; Ghemawat 2003; Hawawini, Subramanian, and Verdin 2004; Makino and Delios 1996). Country contextual effects are classified as either economic or institutional in nature (Goldszmidt, Brito, and de Vasconcelos 2011). In the institutional part, when MNEs operate in different markets, they face challenges in strategically locate their subsidiaries and adapt to the diversity of institutions across countries and regions (Jackson and Deeg 2008, pp. 540). In that sense, "institutions matter", and we now witness a growing interest within scholarly investigation to incorporate and explore institutional arguments within the international business research (e.g. Christmann et al. 1999; Dikova 2009; Ghemawat 2003; Konara and Shirodkar 2018; Spencer and Gomez 2011; Hughes et al. 2017). Within this literature, differences in national institutional environments influence performance, as they affect industry structure, the construction of firm's resource base and the appropriation of the economic rents generated

by them (Dunning and Lundan 2008; Michailova and Zhan 2015). Thus, the capacity of subsidiaries to be effectively embedded within their local institutional contexts may be indispensable to their success (Hutzschenreuter, Kleindienst, and Lange 2014).

The institutional paradigm (North 1990; Oliver 1991; Scott 1991) combines economic-oriented and sociological approaches to direct attention at forces that lie beyond organizations and industry boundaries. The theory is rooted back in the seventies; tracing its origins to the seminal work of Meyer and Rowan (1977) which discussed the impact of external influences on organizational development. According to the institutional standpoint, firms co-evolve with their environment (Cantwell, Dunning, and Lundan 2010). Thus, organizational actions are seen not only as choices among alternatives derived from firm-internal arrangements; but rather as choices defined by a range of options determined by firms' external environment (Scott 1991). These external influences are manifested in institutions, which may be broadly defined as the regulative, normative, and cognitive pillars (Kostova 1997; Scott 1995) that guide individual and organizational behaviors.

Within international business, institutional perspectives see different routes of inquiry on subsidiary performance. Previous research on the institutional dimensions-performance relationship has focused on the magnitude and direction of home-host institutional differences, emphasizing the impact of institutional distance (e.g. Chao and Kumar 2010; He, Jianhong, and Jinmeng 2015; Konara and Shirodkar 2018; Kostova 1999), recording mixed empirical evidence (Konara and Shirodkar 2018). In general, institutional distance, defined as "the extent of similarity or dissimilarity between the regulatory, cognitive, and normative institutions of two countries" (Xu and Shenkar 2002, pp. 608), seems to reversely affect increased performance levels (e.g. Dow and Ferencikova 2010; Ghemawat 2001). Thus, subsidiaries from similar institutional environments tend to outperform those from distant institutional contexts. To rephrase this argument, MNE subsidiaries are motivated to become more isomorphic with their institutional environment in order to enhance their legitimacy and performance. Others researchers though (e.g. Dikova 2009; Evans and Mavondo 2002) posit that a larger institutional distance may increase performance because it motivates firms to undertake more aggressive research for better strategic decision-making (Trapczynski and Banalieva 2016, pp. 826). Relevant considerations in the institutional – subsidiary performance links addressed more specifically the importance of the physical distance between the center and the periphery of the network (Dikova 2009), and MNEs' regional experience (Dikova 2009; He, Jianhong, and Jinmeng 2015; Luo 2001). Other researchers focused on institutional pressures to transfer practices

and human capital development (Edwards and Kuruvilla 2005; Jensen and Szulanski 2004), and the impact of institutional changes on firms' profitability and growth (Peng 2001). These areas of inquiry are often interrelated. For instance, some studies (e.g. Kostova 1999) have looked into problems in the transfer of organizational knowledge and practices, due to differences in institutional contexts determined by institutional distance.

With few exceptions (e.g. Tao et al. 2018), the quality of the local institutional context *per se* in influencing subsidiary performance is much less studied in international business research (Lynch and Jin 2016). This is especially important for emerging and transition countries, that struggle to find their way toward a market-based economy, posing important institutional challenges to foreign firms. The institutional quality refers to the degree of stability and development of the institutional infrastructure of host countries, which includes the set of laws, regulations, administrative procedures and policies formally sanctioned by the government (Cuervo-Cazurra and Genc 2008). In this direction, Huther and Shah (1996, pp. 40) linked the notion of institutional quality with governance quality, defining the latter as "… all aspects of the exercise of authority through formal and informal institutions in the management of the resource endowment of a state." Governance transcends the institutional framework, by encompassing the *interaction* between formal and informal institutions, rules, and relations (including for instance social norms and corruption perceptions).

Firm performance is affected by the governance quality prevailing in a specific country (assuming in the main a positive association), since it is a factor that directly influences its costs and competitive foundations. For instance, Johnson, McMillan, and Woodruff (2002) show that better property rights institutions make firms' more likely to reinvest their profits in the business. In a similar vein, Ward, Yasar, and Maurisson (2010) find that the protection of property rights is positively related to firm productivity. As said, broadly defined, governance quality refers to the process by which public authority is exercised in the management of a country's social and economic resources; and the capacity of governments to achieve the objectives they are supposed to address (World Bank 1994; 2000). In most empirical investigations (e.g. Manolopoulos and Vavouras 2014; Rajkumar and Swaroop 2009; Thomas 2010) governance quality is assessed through the World Bank Worldwide Governance Indicators (WGI). WGI consist of six composite indicators (or dimensions), i.e. voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption; classified into three groups: (i) the process of government selection, monitor and replacement, (ii) the capacity of governments to formulate and execute sound policies, and (iii) the existing institutions that govern citizens' and the state mutual economic and social interactions

(Kaufmann, Kraay, and Mastruzzi 2003). The aim of these six indicators is to evaluate the capacity of the public sector to implement policies that influence the macroeconomic and microeconomic environment in a specific country.

Based on the aforementioned considerations, we formulate the following research questions that serve as the direction for our empirical research:

Research Question 1. Is the host institutional context *per se* an influential predictor of MNE foreign subsidiaries' performance?

Research Question 2. How the dimensions of the host governance quality impact on subsidiaries' performance levels?

Research design

Research setting

Following the tradition established in location studies (e.g. Alcacer 2006), we test our predictions using a cross-sectional sample of foreign operations located in Turkey. We argue that the specific setting provides an interesting test case for our research purposes: in Turkey, the dominant developmental state characteristic is rooted in *Kemalism*, the official ideology of the state (Özen and Akkemik 2012, pp. 523). The "nationalism" principles of this ideology, in particular, have assigned the state a central role in the national economic development, formulated as "catching-up" with the "developed" Western world (Eralp 1990). To achieve this objective, during the eighties public policy in the country changed sharply from a state-oriented approach toward market-based solutions. This shift has transformed the local institutional context and created unique challenges for foreign investors.

The effects of liberalization policies that took place in the economic scenery of the country have been revealed within two decades. According to World Bank reports, Turkey's performance to attract foreign investments since 2000 has been impressive. During this time, Turkey opened up to foreign trade and finance, harmonized many laws and regulations with European Union (EU) standards, and offered multiple incentives to foreign firms. As a result, according to the global consultancy firm Ernst & Young, in recent years the country has become the tenth most attractive foreign direct investment destination in Europe. Between 2009 and 2013, the number of foreign projects in the focal economy increased by 129%. In 2015, Turkish government agencies reported an increase of 32% in foreign investments. The increased quantity and considerable quality of investment inflows in the country offers an ideal setting for our study, since it displays trends and features that could also characterize other emerging economies

(see for instance Brookfield 2010; Luo and Chung 2005). On the other hand, significant political risks associated with investment and capital flows create institutional challenges for ensuring investment security.

Sampling, data collection and survey instrument

We gleaned information for our sample from a comprehensive database of foreign operations in the country over the period 2000 to 2013 provided by the *International Security Exchange (ISE)* and the *International Investors' Association (YASED)* directories; backed up from the *Union of Chambers of Commerce, Industry, Maritime Trade and Commodity Exchanges of Turkey (TOBB)*. All the databases employed here are considered as authoritative sources of information, providing complete coverage of company investments in Turkey and up-to-date, firm-level information on foreign activities. Our final sampling population included 857 inward foreign investments. After accounting for responses with missing data, 104 questionnaires were gathered. The response rate (12.13%) seems adequate for international business, organizational theory and strategic management empirical literature and does not constitute a study limitation. The number of respondents for EU MNEs, U.S. and MNEs from the rest of the world (mainly Asia) were 46 (44.2%), 22 (21.2%) and 36 (34.6%), respectively. Among these 104 foreign operations, 38 (36.54%) are classified in the manufacturing sector and 66 (63.46%) as services' industries. 49 (47.11%) out of them are wholly owned subsidiaries (WOS), while 55 (52.89%) have been formed through an international joint venture (IJV). The average years of subsidiaries' operation in the focal market is 20.55 years (*std. dev* = 20.61). 12.5% of the responding firms had 10 or less employees (micro subsidiaries), 20.19% had between 11 and 50 employees (small subsidiaries), 18.27% were medium-sized enterprises (between 51 and 250 employees), and 49.04% were large subsidiaries (over 250 employees). According to this distribution of surveyed firms, it is reasonable to assume that our sample seems to be skewed toward larger firms and this possible bias should be kept in mind when interpreting the results. The possibility of non-response bias was checked by comparing the characteristics of the respondents with those of the original population sample. The calculated t-statistics for independence for country of origin and subsidiary age were statistically insignificant; suggesting that our sample does not suffer from non-response bias.

Data for this study were collected through a combination of questionnaire responses and secondary sources. The following two steps guided the development of our survey instrument: (i) a review of extant literature to identify measures that would appropriately capture our core explanatory

constructs under investigation, and (ii) interviews with five subsidiary corporate-level executives to understand and clarify the phenomena of interest. A draft questionnaire was developed which was pretested with experts in the field and yield the final version of our survey instrument. A personalized cover letter accompanying each questionnaire explained the purpose of the study and provided assurances regarding anonymity and confidentiality. This approach encourages respondents to answer honestly and reduces the potential for modifying their responses due to social desirability bias.

Our questionnaire was addressed to subsidiaries' top managers (see Bingham and Haleblian 2012, for a definition). Conceptually, top managers satisfy two accepted criteria for their identification as appropriate key respondents: (a) possession of sufficient knowledge of subsidiary strategies and procedures, and (b) adequate level of involvement with regard to the issues under investigation.

Measurement of constructs

Dependent variable

Our dependent variable was *subsidiary performance* (PERF); measured as the annual turnover of the firm (in $US million). In general, financial indicators are favorable constructs for evaluating firm performance (e.g. Lu and Beamish 2001; Manolopoulos 2018) and annual turnover is frequently regarded as a key indicator of firm success. In order to sort the performance levels of subsidiaries, a four-point Likert-type scale was prepared, where the scale value "4" indicates an annual turnover over $US 50 million, "3" between $US 11 and $US 50 million, "2" between $US10 and $US 1 million, and the scale value "1" indicates an annual turnover of the firm less than $US 1 million.

Independent variables

Most of the study's (five out of six) institutional constructs were captured through multiple questionnaire items. Respondents evaluated each item reflecting their perceptions of governance quality (QoG) on one-to-five-point Likert-type scales. The dimensions of QoG are operationalized in Table 1.

Controls

We have included in our analysis a number of organizational controls that prior research has shown as affecting firm performance. Entry mode decisions impact on the range of strategic options available to the subsidiary (Brouthers and Hennart 2007) and, consequently, to its financial

Table 1. Operationalization of independent (quality of governance) constructs.

Multi-item constructs and items	Scale item 1	Scale item 5	CFA factor loadings	Composite reliability	Cronbach's alpha
Voice and accountability (measured on discrete, five-points Likert scales)					
Please evaluate the impact of the following statements on your firm's competitiveness and performance					
Transparency in public administration	Trivial	Very influential	0.678	0.789	0.783
Accountability of law-making bodies	Trivial	Very influential	0.727		
Accountability of public officials	Trivial	Very influential	0.701		
Political Stability (measured on discrete, five-points Likert scales)					
Please evaluate the following statements					
Stability of the government	Unstable	Stable	0.761	0.714	0.703
Social unrest[a]	Highly unlikely	Very likely	0.682		
Risk of political instability	High	Low	0.657		
Threat of violent events[a]	Highly unlikely	Very likely	0.617		
Government effectiveness (measured on discrete, five-points Likert scales)					
Please evaluate the impact of the following statements on your firm's competitiveness and performance					
Extent of bureaucracy	Ineffective	Effective	0.669	0.739	0.726
Quality of infrastructure	Low	High	0.667		
Regulatory quality (measured on discrete, five-points Likert scales)					
Please evaluate the prevalence of the following for your business					
Discriminatory tarrifs[b]	Very prevalent	Not prevalent at all	0.489	0.748	0.735
Excessive taxation	Very prevalent	Not prevalent at all	0.785		
Trade barriers[a]	Low	High	0.736		
Unfair competition practices	Very common	Not common	0.698		
Rule of law (measured on discrete, five-points Likert scales)					
Please evaluate the prevalence of the following for your business					
Protection of intellectual property rights	Not prevalent	Very prevalent	0.673	0.795	0.786
Enforcement of the laws	Not prevalent	Very prevalent	0.717		
Stable legal environment	Not prevalent	Very prevalent	0.755		
Parallel economy	Not prevalent	Very prevalent	0.641		
Control of corruption (measured on discrete, five-points Likert scale)	Not effective	Very effective			

Notes: [a]reverse-coded item
[b]item dropped due to low factor loading
$N = 104$; chi-square = 99.17; $p = 0.005$; CFI = 0.922; RMSEA = 0.044; SRMR = 0.057.

performance (Shaver 1998). Here, subsidiaries' *mode of entry* (MoE) was captured by a dummy 0-1 variable that equals 1 if the subsidiary has entered the local market via a WOS (drawn from Manolopoulos 2014). Subsidiaries' *country of origin* (ORIGIN) (a dummy variable, where 1 = EU MNE and 0 = MNE outside EU) is also associated with their performance (Noorderhaven and Harzing 2003). Finally, following Hughes et al. (2017), subsidiary age, size and sector of activity were selected as control variables as each can affect performance levels. *Sector of activity* (SECT) is captured with another dummy variable (1 = manufacturing, 0 = services). *Subsidiary size* (SIZE) was measured using a four-point Likert-type scale (1 = subsidiaries with less than 11 employees, 2 = subsidiaries that employ between 11 and 50 employees, 3 = subsidiaries that employ between 51 and 250 employees and 4 = subsidiaries with more than 250 employees). Finally, *years of operation* (YoP) indicate the number of years the subsidiary has been established in the local market.

Validation and psychometric properties of the measurement scales

A consideration of the research was the minimization of common method concerns. To correct for such effects, the following precautions were taken: first, our dependent variable was measured using secondary data, whereas our core independent variables were measured in the questionnaire by the use of perceptual evaluations. Further, a number of controls (e.g. size, years of operation and country of origin) are archival, obviating any danger of common method bias with them (Manolopoulos, Chatzopoulou, and Kottaridi 2018). This diversity in the data sources reduces the likelihood of common method bias. In addition, scale anchors were reversed in specific items of the questionnaire to reduce and compensate for the development of response patterns. These precautions afford some confidence that any potential bias coming from our approach is likely to be minor.

The psychometric properties of our measurement scales were evaluated by the following accepted practices in the literature: to assess the validity and reliability of our measures, we employed confirmatory factor analysis (CFA) to test whether our multi-item measures are associated with their respective constructs. During this process, each item was restricted to load on a priori specified factor, while allowing the underlying factors to correlate (Manolopoulos, Chatzopoulou, and Kottaridi 2018). Our baseline measurement model yielded a good fit to the data: chi-square (χ) = 99.17, p=.005; comparative fit index (CFI) = 0.922; root mean square error of approximation (RMSEA) = 0.044 and standardized root mean square residual (SRMR)=0.057. Also, all items load highly to their corresponding factor, providing thus evidence of the uni-dimensionality of our constructs

(Anderson and Gerbing 1988). Except for discriminatory tariffs (which nevertheless is higher than 0.4), the values of all the remaining factor loadings are higher than that of 0.6. Further, the composite reliability was very satisfactory since it was above the 0.70 cutoff point for our constructs, while the same also applies to the Cronbach's alphas. Consequently, a large number of measures are free of random errors. These findings provide evidence for the convergent validity of our regressors.

Results and discussion of findings

Analysis of results

Table 2 reports the means, standard deviations and pairwise Pearson correlations between our dependent variable and all the regressors used in this study. All bivariate correlations are below the 0.70 threshold level and no high correlations have been reported (two-tailed p). Further, since most of the correlations between the core exploratory and control variables are moderate to low and the variance inflation factors (VIFs) are well below the recommended by Allison (1999) threshold of 2.5 (mean VIF = 1.22), multicollinearity does not seem to be a serious concern to our analysis.

Since subsidiary performance takes one of four values for each performance level, it corresponds to a specific range, being at the same time ordinal in nature. In this case, ordered probit (OP) analysis is the econometrically preferred specification to capture the ordinal ranking of our dependent variable. Before presenting regression results, the validity of our model has been assessed. Regression diagnostics are portrayed in Figure 1. From the graph, it can be inferred that our model satisfies the assumptions of linearity, normality and homogeneity of variance. Also, our models return high levels of chi-square values rejecting the null hypothesis of model misspecification at the 0.01 percent level.

Our regression results are displayed in Table 3. We first estimated a baseline model (Model 1), reporting only the results of the controls (organizational demographics) on the dependent variable. Next, we introduced the terms testing the impact of governance quality dimensions on subsidiary performance (Model 2). Model 2 represents an improvement over the respective baseline model (R-squared$_{model2}$: 0.152, R-squared$_{model1}$:0.090), indicating the explanatory power of local governance quality in the performance measure. Before discussing the impact of institutional constructs on foreign subsidiaries' performance, it should be noted that in both our specifications (Models 1 and 2), among all the control variables under investigation, only subsidiary size was found to be constantly and significantly positively related to the performance variable ($p<.001$). This finding contradicts evidence developed in the literature suggesting a negative

Table 2. Means, standard deviations and correlation analyses.

Variables	Mnemonic	Mean	Std. Dev.	Min	Max	1	2	3	4	5	6	7	8	9	10	11	12
1. Subsidiary performance	PERF	3,009	1,065	1	4	1											
2. Voice and accountability	VA	3.34	0.963	1	5	0.044	1										
3. Political stability	PS	2.94	0.635	2	5	0.158	−0.030	1									
4. Government effectiveness	GE	3.34	1,077	1	5	0.123	0.033	0.057	1								
5. Regulatory quality	RQ	3,067	0.776	1	5	−0.039	−0.058	0.227	0.057	1							
6. Rule of law	RoL	3.27	1,018	1	5	0.221	−0.158	0.249	0.227	0.426	1						
7. Control of corruption	CORR	3.22	1,336	1	5	0.073	−0.258	0.209	0.259	0.198	0.353	1					
8. Mode of entry	MoE	0.471	0.502	0	1	−0.008	0.127	−0.001	0.127	0.014	0.071	−0.047	1				
9. Country of origin	ORIGIN	0.442	0.449	0	1	−0.099	−0.018	−0.154	0.015	−0.053	0.045	0.012	0.017	1			
10. Sector of activity	SECT	0.365	0.483	0	1	0.106	0.059	−0.057	0.059	−0.040	−0.051	−0.006	0.094	0.007	1		
11. Size of subsidiary	SIZE	3,038	1,096	1	4	0.431	0.060	−0.163	0.217	0.008	0.120	0.067	−0.034	0.075	0.137	1	
12. Years of operation	YoP	20.55	20.61	4	179	−0.084	−0.066	−0.054	0.065	0.028	−0.073	0.015	0.077	−0.041	−0.287	−0.168	1

Notes: Correlations above 0.075 are significant at the $p < 0.05$ level $N = 104$.

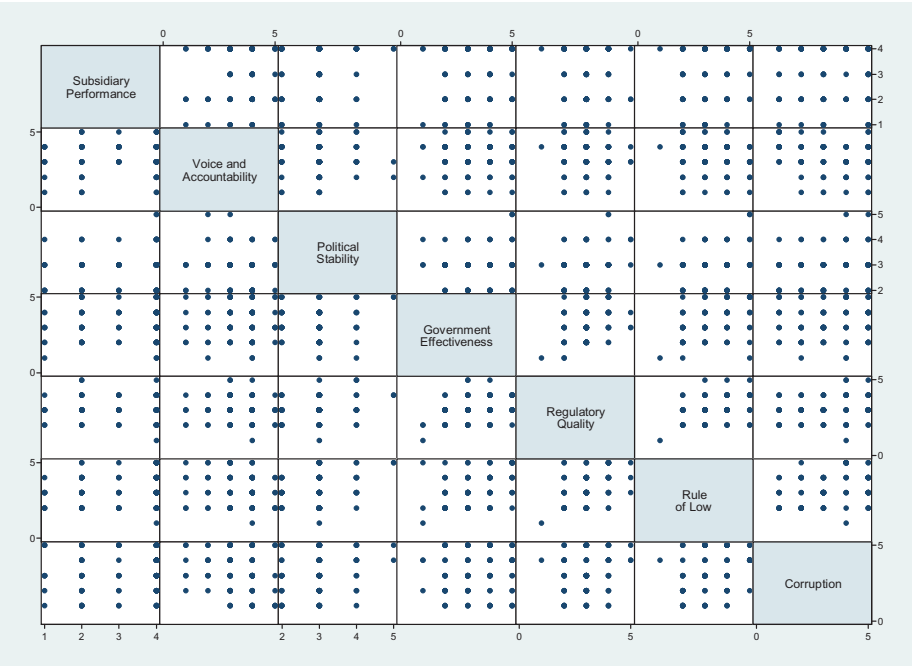

Figure 1. Regression diagnostics.

relationship between size and firm performance (e.g. Lu and Beamish 2001). Surprisingly enough, despite scholarly evidence for the opposite case (e.g. Brouthers, Brouthers, and Werner 2008; He, Brouthers, and Filatotchev 2013), in our study subsidiaries' mode of entry is not associated with their performance outcomes. The same applies to country of origin, years of operation and sector of activity.

Coming back to our hypothesized predictions, our first research question attempts to evaluate the impact of local institutional quality on subsidiary performance. Model 2 provides support for the positive and statistical significant association between most of the quality of governance indicators with increased subsidiary performance levels. Therefore, it can be supported that the quality of host governance enables foreign subsidiaries to increase their performance and that MNE operations in environments characterized by well-developed institutions have gains accrued at the subsidiary level (Wu et al. 2016). We then hypothesize that in host countries characterized by a strong institutional context, subsidiaries capitalize on institutional advantages to develop their resources and capabilities. This may enhance their potential to stake a claim for advanced competitiveness in the wider MNE network (Cuervo-Cazurra 2008; Luo and Tung 2007).

Our second research question attempts to identify the effects of local governance quality dimensions on subsidiary performance. According to evidence provided, a statistically significant, positive relationship between

Table 3. Regression analysis.

ψ (Subsidiary performance)	Model 1: (controls only)	Model 2: (complete model)
Voice and accountability[a]		0.036
		(0.128)
Political stability[a]		0.536***
		(0.022)
Government effectiveness[a]		0.223*
		(0.133)
Regulatory quality[a]		0.320*
		(0.174)
Rule of law[a]		0.330**
		(0.153)
Control of corruption[a]		−0.046
		(0.095)
Mode of entry	0.005	−0.084
	(0.218)	(0.338)
Country of origin	−0.354	−0.292
	(0.229)	(0.240)
Sector of activity	0.079	0.177
	(0.241)	(0.248)
Size of subsidiary	0.470***	0.542***
	(0.112)	(0.122)
Years of operation	−0.001	0.005
	(0.004)	0.004
LR chi-square	22.42	35.36
Prob > chi-square	0.0004	0.0002
Pseudo *R* square	0.0902	0.1523
Log pseudo-likelihood	−1,13,032	−1,24,240

Notes:
*significant at 0.05, **significant at 0.01, ***significant at 0.001.
[a]Entrepreneurial perceptions.
[b]Robust standard errors in parentheses.
N=104.

political stability, government effectiveness, regulatory quality and rule of law has been recorded (at the .001, .05, .05, and .01 levels of significance respectively). Our findings are in line with the work of Manolopoulos, Chatzopoulou, and Kottaridi (2018), indicating that the capacity of governments to formulate and execute sound policies reduces agency and transaction costs, help firms overcome information asymmetries and promote entrepreneurial performance. Further, we corroborate Maskus (2000), who has argued that well-defined and transparent laws encourage investments and improve performance. Finally, the stability of the political environment seems to reduce uncertainty and secure the profitability initiatives of firms (Schneider and Frey 1985; Rodrik 1991). These findings, in the main, reaffirm the importance of local governance quality for MNE subsidiaries' competitiveness, value, and profitability.

Discussion of findings

The main findings to us seem to be the following: first, the role of country conditions in determining subsidiary outcomes seems to be particularly

important. Lending support to the work of Christmann, Day, and Yip (1999), positing that country conditions affect the business climate for MNE subsidiaries operating in a particular country, here we claim that the quality of governance, as a country conditional factor, influence significantly subsidiaries' performance. This result is in line with the works of Khanna and Palepu (1997) and North (1990), arguing that well-developed institutions reduce uncertainty and lower transaction and search costs, boosting in that way firm performance. Second, extant research provides conflicting evidence about whether MNEs can benefit from the geographical dispersion of their subsidiaries (Hitt, Hoskisson, and Kim 1997; Wu et al. 2016). Here we argue that MNEs' expansion in countries with strong institutional contexts has positive competitive and performance implications for their foreign subsidiaries. This may be attributed to the fact that a well-functioning local institutional environment may advance subsidiaries' performance by allowing access to efficient factors of production, reducing uncertainty and associated costs. We thus extend prior theorizing by proposing that the positive effects of internationalization on firm performance can be explained not only by the one-way transfer of parent resources and capabilities to their geographically dispersed subunits but also by the host country level of institutional quality (Wu et al. 2016). In this regard, institutional development and associated market reforms may lead subsidiaries to a reduced reliance from MNE-internal capabilities, drive them to develop distinctive competitive advantages and claim a more value-added role within MNE network operations. Thus, we add to environmental determinism theory (Hannan and Freeman 1977; Hannan and Freeman 1989) which argues that firm outcomes are mainly determined by factors that are not controllable by its management. Third, we argue that the local institutional context cannot be treated as a unidimensional construct by international business researchers. Our findings indicate that subsidiaries do not perceive that all six dimensions describing QoG prevailing in a country as being of equal importance, as far as their direct impact on their cost functions and generated revenues is concerned. Finally, we stress the relevance of political stability as the most important feature of governance quality that influences positively firm performance. An unstable political situation and associated risks seem to adversely affect the performance of firms operating within the country, making it more difficult to keep revenues growing as fast as costs. It has been also revealed that regulatory institutions are very influential in determining subsidiaries' elements of competitiveness. There are clear implications of this study for MNE managers and policymakers. The determinant effect of country conditions on subsidiary performance suggests that MNE managers should very carefully scrutinize and evaluate the quality of governance in the markets they

intend to enter. This strategic choice will lead the multinational organizations to significant competitive advantages and maximize the value-addition of their investments. Further, since our analysis relates subsidiaries' performance with the institutional context they operate, our findings show how subsidiary managers could manage their internal operations in external institutional settings. Finally, the importance of the QoG in determining subsidiary performance suggests that a critical skill for MNE management is to hedge efficiently against the exposure of their subsidiaries to political instability, regulatory burdens and government ineffectiveness in the markets they operate (Lynch and Jin 2016). Policymakers, on the other hand, should ensure the QoG within their countries so as to attract more quantitative and qualitative investment inflows.

Conclusions and limitations

In this paper, we analyze the relationship between host institutional quality and MNE foreign subsidiaries' performance. There are currently two highly differing theories in the literature, i.e. the MBV and RBV of the firm, to explain why some firms perform in a superior manner and are associated with higher value than others. Yet, with some notable exceptions (see for instance Lecraw (1983) and Douglas and Craig (1983) for the MBV model and Fang et al. (2007), and Fey and Bjorkman (2001) for the RBV), these theoretical perspectives clearly point to different sources of competitive advantage and tend to under-research the performance determinants of MNE foreign subsidiaries. Our research extends, to consider the important role played by institutional forces, which MBV and RBV studies have not fully addressed. According to our results, subsidiary performance seems to be positively influenced by institutional effectiveness. In this way, we complement the arguments developed by the burgeoning body of RBV and MBV research, positing that it is not only the transfer of MNE intangible assets and capabilities, or a favorable and unbiased industry structure that promote subsidiary growth, but also the high quality of local government institutions that exercise and implement laws and policies. Among all institutional dimensions, political stability, regulatory quality, government effectiveness, and rule of law emerge as the most influential predictors of subsidiary competitiveness.

This work contributes to the literature in two main ways: first, it adds to research that develop institutional theory in the international market place (e.g. Brouthers and Brouthers 2000; Xu and Shenkar 2002). In particular, we focus on the "performance consequences" role of institutional constructs in MNE subsidiary operations (e.g. Dikova 2009; Hughes et al. 2017; Kafouros and Aliyev 2016). In this regard, we respond to calls for more

integrated research investigating the determinants of subsidiaries' growth. Second, we deviate from the extensively studied concepts of *institutional pressures* and *institutional distance* in international business studies, and focus on the quality of governance as an indicator of institutional effectiveness. By using WGI, we empirically show that different dimensions of governance have a differentiated impact, both in magnitude and scale on foreign subsidiaries' performance.

Limitations of the study

As with every empirical study, our results are subject to a series of caveats. Five of them are reported here: first, and maybe most important, we did not consider the influences of the industry structure or MNE resources and resource heterogeneity in examining the proposed relationships. Yet, there is strong evidence to support that firm performance is determined by a range of firm-level and competition-based factors (Barney 1991; Porter 1980). Second, while there are several constructs measuring institutional context, such as the economic freedom index (Estrin et al. 2008), here we focus on governance quality. The consideration of other institutional measures would provide us with additional insights on the impact of local institutions on subsidiary performance. Further, our results should be viewed in light of the single-country research context. We focus our research in Turkey, and this may limit the generalizability of our findings. Countries have different economic and political conditions; therefore, a replication of the study in multiple country environments would provide us with more consistent results. In addition, in our sample almost half of subsidiaries under investigation are large enterprises. A more equivalent distribution of the sampled firms would provide us with additional insights on the relationship between institutional quality and performance of medium-sized and smaller firms. Finally, the use of a single performance indicator for measuring performance is also considered a limitation of this study, hindering its generalizability.

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