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# The Impact of CSR Strategy of Affiliated Firm on Performance in the Emerging Markets: Resource-Based and Institutional Approaches

***Cho, Youngsam,*** Associate Professor, College of Business Administration, Gyeongsang National University, Rep. of Korea


## Abstract

This study suggests an integrated theoretical framework for the relationship between political risk and multinational corporation (MNC) subsidiary's performance in the emerging market. The political risk would have a negative impact on MNC subsidiary's performance in the emerging countries that are developing in Asia, the Commonwealth of Independent States, Africa, and South America. The major reason is that political risks could generate a loss of benefit or a loss of control for MNC's subsidiary. In this study, I suggest that corporate social responsibility (CSR) strategy would be a solution to overcome various political risks. Specifically, the affiliated firms with diversified industries or greater financial resources could mitigate the negative impact of political risk than unaffiliated firms. Because they can use their tangible or nontangible asset such as information, technology, and construction in order to gain legitimacy and trust from local government, local community, and local firms in the emerging market. Finally, I claimed the costs of the affiliated firms would exceed the benefits at the initial stages, while the benefits of affiliated firms would exceed the costs over time when political risks become higher. The reason is that the trust gained from local stakeholders accumulates over time and the impact of CSR strategy would become an important solution to overcome the risks in and unstable context.


**Key words:** Affiliated Firm, Political Risk, CSR Strategy, Subsidiary Performance, Emerging Market

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# 1. Introduction

Multinational corporations (MNCs) which enter emerging markets to explore resources have steadily increased. They could have sustained competitive advantages by obtaining non-imitable tangible or intangible resources (Barney, 1991). However, they have been faced with some political problems. The risks gave MNCs from western country or developed country, as well as Korean firms, considerable financial damages. Since these institutional risks are negatively related to performance of foreign firms, the issues are important for the firms which invest the emerging markets. Direct or indirect political risks have been major concerns for firms (Farge & Wells, 1982; Wheeler & Mody, 1992). Political risk is considered as loss of benefit for a corporate or loss of control for ownership by local government (Fitzpatrick, 1983). Local governments have expelled foreign firms or tightened regulations through the policy like a heavy tax for foreign firm to protect the resources in their markets.

In respond to those political problems, MNCs have been required to prepare proper strategies. That is, they should pursue the way that reduces the opportunistic behaviors of local government or increase the cost for contingency plans. Some researchers suggested several strategies (alternative solutions) to overcome political risks. MNCs could build joint venture partnership with local firms which have local power (Henisz, 1998). MNCs could enhance the bargaining power by making local government rely on their subsidiaries (Zelner & Henisz, 1999). In terms of resource-based view, they could reinforce internal competency or experience to prepare for the risk (Barney, 1986; Teece, 1980).

In this study, I emphasize the role of corporate social responsibility (CSR) strategy as one of the effective solutions to overcome the political problems in the emerging markets. CSR may be defined in general terms as the obligation of the firm to use its resources in ways to benefit society (Kok et al., 2001). Porter & Kramer (2006) regarded corporations' investment in local infrastructure as a strategic CSR. Also, Marquis et al. (2007) use a concept "corporate social action" often called "corporate social responsibility". They considered creating a social infrastructure including economic development, housing, public safety, and local environmental efforts as a CSR. Corporations contribute to the social infrastructure in poor countries as a CSR activity (Aslaksen & Synnestvedt, 2003).

Thus, CSR activities may include building infrastructure like road, rail, communication network, housing, and etc., education for employees or students, and financial support for local community. Therefore, those activities can make MNCs give favorable image to the stakeholders of local market. Although CSR activities of MNCs involve considerable costs at initial stage, the benefits would exceed the costs over time by gaining legitimacy and trust based relationship in the emerging market in long term view. Specifically, these impacts could be seen more distinctly, as the political risks originated from neo-resource nationalism have increased since 2000s. However, CSR strategy of foreign firms could not be competitive advantage to overcome political issues in developed countries compared to emerging markets, since their markets are already well developed in terms of infrastructure, technology, or etc. Thus, I focus on the impact of CSR activities of MNCs on their performance in the emerging markets.

I distinguish between two types of firms such as affiliated firms and unaffiliated firms. In this study, affiliated firms mean not only group affiliation, but also industrial diversification. The reason is that the affiliated firms with industry diversification could play a variety of roles more than unaffiliated firms in the emerging markets. A firm's level of CSR is related to its size, level of diversification (McWilliams & Siegel, 2001). Diversified firms can build infrastructure or aid local community by using their technology or material in industries where they are doing business. As mentioned earlier, such local CSR activities could help MNCs to gain legitimacy or build a trust based relationship in local markets in long term view. Based on these elements, I suggest the theoretical model.

In this study, I pursue three research questions through two theoretical lenses, resource-based view and institutional perspective. First, I examine how political risks influence foreign firm performance when local governments strengthen the regulations to foreign firms as a basic question. Second, I investigate the moderating effect of CSR activities of the affiliated firms on the negative relationship between political risk and foreign firm performance. Third, I research the difference of performance between affiliated firms and unaffiliated firms in terms of the costs and benefits during unstable period (high political uncertainty since 2000s) compared to during stable period. Overall, this study is designed to understand firm's behavior from the resource-based and institutional perspectives. I discuss the reason why MNCs enter emerging markets in spite of the political risks and the solution that could make MNCs overcome the political uncertainty.

## 2. Literature review and propositions

### 2.1 Resource-based approach and emerging markets

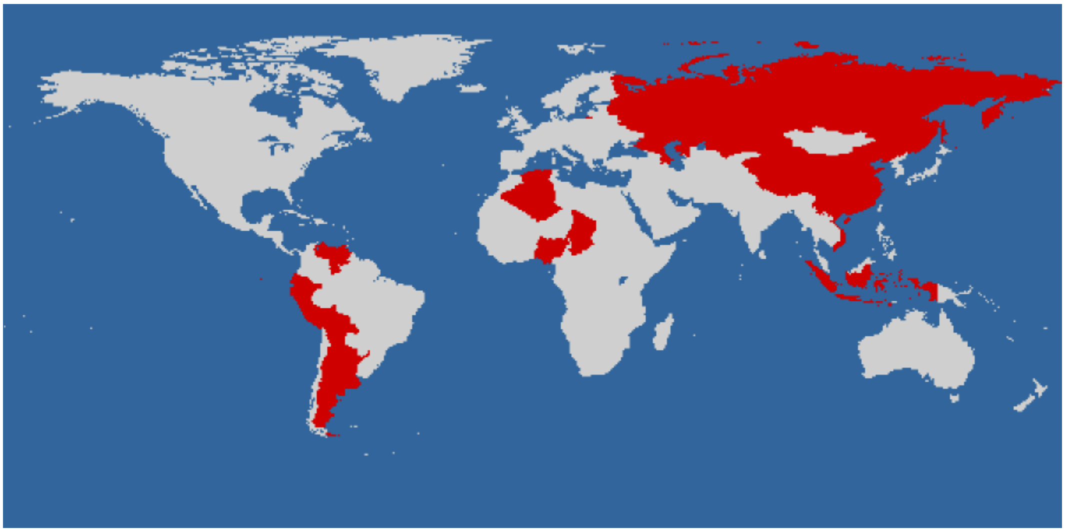
Although there are relatively high political risks in the emerging markets, foreign firms are willing to enter the markets. Even they may cost more than the value of resources which they pursue. We can find the answer from resource-based perspective. Firms could have sustained competitive advantages by obtaining valuable, rare, imperfectly imitable, and non-substitutable resources (Barney, 1991). Firm resources include physical resources like the physical technology used in a firm, a firm's plant and equipment, its geographic location, and its access to raw materials (Williamson, 1975), human capital resources like the training, experience, judgment, intelligence, relationships, and insight of individual managers and worker in a firm (Becker, 1964), organizational capital resources like a firm's formal reporting structure, its formal and informal planning, controlling, and coordinating systems, as well as relations among groups within a firm (Tomer, 1987).

Economists including Williamson insisted firms within an industry or firms within a strategic group are identical. Also, resource heterogeneity should develop in an industry or group and this heterogeneity will be very short lived because of the high mobility of the resources. On the other hand, Barney (1991) argued that firms within an industry or group may be heterogeneous. Also, resources may not be perfectly mobile across firms, and thus heterogeneity can be long lasting. That is, sustained competitive advantage is possible, since firms are heterogeneous. Ghoshal & Moran (1996) insisted what really differentiate markets and firm is that they are able to achieve efficiency and facilitate adaptation in different ways, following different institutional logics. Thus, we can conclude that one of the reasons that a lot of foreign firms enter emerging markets despite of political risk or poor business condition is that they pursue the resources which give them sustained competitive advantages.

In this study, I focus on physical resources like natural resources and access to raw materials. That is, I examine that the MNCs interested in seeking natural resources have to go after certain resources that are tied to particular foreign locations, such as oil in the Middle East, Russia, and Venezuela. Those resources will be growth drivers which give them sustained competitive advantages in the future. Furthermore, I concentrate on the limitation of natural resources. Barney (1991) suggested that imperfectly imitable resources could be divided into unique historical conditions, causal ambiguity, and social complexity.

First, in terms of unique historical conditions, most researchers hardly argue that firms do not vary concerning their unique histories, but rather that these unique histories are not relevant to understanding a firm's performance (Porter, 1980). This approach suggests that not only are firms intrinsically historical and social entities, but that their ability to acquire and exploit some resources depends upon their place in time and space. Once this certain time in history passes, firms that do not have space and time dependent resources cannot acquire them, and thus these resources are imperfectly imitable. For example, valuable locations which access to natural resources, scientists, and unique and valuable organizational culture depend upon the unique historical position of a firm. Second, in terms of causal ambiguity, the relationship between the causal ambiguity of a firm's resources and imperfectly imitability has received systematic attention (Reed & DeFillippi, 1990). In this situation, causal ambiguity exists when the link between the resources controlled by a firm and a firm's sustained competitive advantage in not understood or understood imperfectly. In other words, if a firm with a competitive advantage understands the link between the resources and its advantage, then other firms can also learn the connection, it could not be a competitive advantage anymore. Third, a firm's resources may be imperfectly imitable, since they may be very complex social phenomena. For example, the exploitation of physical technology in a firm often reflects the use of socially complex firm resources. Some firms may all possess the same physical technology, but only one of these firms may possess the social relations, culture, traditions, and etc. to exploit this technology in practicing strategies (Wilkins, 1989).

In this article, I focus on the first characteristic, unique historical conditions. As noted earlier, firms need natural resources such as crude oil, natural gas, iron ore, rare metals, and etc. and valuable locations which access to such resources in the emerging markets. Such acquirement could bring the sustained competitive advantages to affiliated firms in a business group in home or other local countries, as well as subsidiaries in a local country. From this perspective, emerging markets such as South America, Soviet Union, Africa, and Asia which have rich natural resources are considerably attractive to MNCs.



**<Figure 1>** Emerging markets including Asia, Commonwealth of Independent States, Africa, and South America

## 2.2 Political risk and firm performance

The institutional perspective explains that organizations follow the social norms and values (DiMaggio & Powell, 1983; Scott, 1995). In other words, structure, behavior, and procedure of the organization are made or controlled institutional factors such as social norm, value, belief rather than official regulations, rational norms, and efficiency in the organization. Political risk could be explained from this view. The Governments and local firms in the emerging markets have same value and norms like ‘nationalism’ or ‘resource nationalism’. These social phenomena are originated from their history. Emerging countries have considerable antipathy toward western countries including U.S. and Europe which have led globalization, since they had to survive in global competition.

Resource nationalism is a developed concept and activity based on nationalism. Nationalism means the ideology involving self-sacrifice and patriotism for independence and prosperity of his or her own country (Webster, 2002). Resource nationalism based on this ideology means a tendency to expand control for resources produced from their own countries in the emerging markets such as South America, Africa, and Asia. It also means policy managing such issues. Emerging countries had tried to achieve economic independence from developed country and escape from poverty through resource nationalism. Resource nationalism was weakened in the

1990s. Political risk has decreased in the emerging markets and increased in developed markets during the past 10 years (Diamonte et al., 1996). It has emerged for the rapid growth of China and India since 2000, again. ‘Neo-resource nationalism’ pursues national interests through the reinforced policies like heavy tax, the increase of premium for local markets, consolidating the control for the ownership of foreign firms, and etc. more than asset forfeiture for foreign firms and expulsion used in the past.

These phenomena appeared in developed countries, as well as in the emerging countries. They call that ideology ‘economic patriotism’ to maximize national interests. It is also based on nationalism. The developed countries including U.S., France, Germany, and Japan have intervened or prohibited global merger and acquisition by foreign firms in various industries such as telecommunication, energy, electronic, steel, shipbuilding, and etc. Economic patriotism in developed countries is seen as a defensive strategy for the survival between the rapid growth of developing countries and competition among developed countries. Weingast (1995) insisted that federalism is one of the political principles for protecting markets in both England and U.S. As mentioned earlier, this study do not concern about developed markets for some reasons.

Simon (1984) addressed theoretical and conceptual issues in political risk assessment, as well as the impact of different environments on the formation of political risk. He divided environments for the multinational enterprise into host country, home country, international, global environments. Host and home country environments include each government actions or policies, societal actions or attitudes, local business community actions, legal community rulings, and media reports. International environment reflects foreign policies such as economic, military, diplomatic of nation states, regional organizations’ and international activist groups’ actions or policies, and internal development in nation states. Finally, global environment involves global organizations’ actions or policies like UN, IMF, global developments such as worldwide inflation, recession, oil crisis, commodity price, fluctuations, and external debt crises. In this study, I emphasized the aspect of host country environment (emerging markets). He also suggested the political risk framework in more detail. The following Table 1 is some parts which reveal the aspects of internal political risks in developing countries within Simon (1984)’s framework. Open or closed means the political system.

<**Table 1**> Internal political risk framework for developing country

| Open | | Closed | |
|---|---|---|---|
| Direct | Indirect | Direct | Indirect |
| Local content rules, joint venture pressure, technology transfer and import or export regulations<br>Strikes, protests, boycotts, negative public opinion<br>Adverse legal rulings<br>Negative media reports | Intra-governmental friction<br>General strikes, elections<br>Local business pressure for subsidiaries, favorable tax rates | Nationalization, expropriation<br>Terrorism, riots, strikes | Coups, radical regime change, leadership struggles<br>Revolution, guerrilla war, riots |

Source: Simon, J. D. (1984). A theoretical perspective on political risk. Journal of International Business Studies, 15: 123-43.

Political risk is that the results that firms do not expect are intervened or regulated by the government (Dunning, 1971). According to Bass et al. (1977), they defined political risk as political event or happening for several specific industries or firms. Robock (1971) distinguished political risk into macro risk and micro risk. Macro risk means that institutional changes have direct effects on all the foreign firms. On the other hand, micro risk influences specific foreign firms or particular business domains. In this paper, I examined the effects of political risk on only foreign firms from the perspective of previous researchers (Bass et al., 1977; Robock, 1971). In the perspective of exploration and exploitation (March, 1991), I focused on the firms which explore the resource in local markets except for the firms that do business such as sale of goods, simply. The reason is that the political risks which this study focuses on related to resource nationalism in the emerging markets. Thus, the results of performance between foreign firms and local firms are quite contradictory.

When political risk increases, foreign firms suffer disadvantages such as heavy tax, the increase of premium for local markets, and consolidating the control for the ownership of foreign firms or for exploring resources in local markets. On the other hand, government provides State-Owned Enterprises (SOEs) with financial support, tax cuts, and a variety of benefits or expand the size of SOEs through merger between SOEs during this period. These policies of government could help SOEs to have competitive advantages compared with the foreign firms. That is, political risk in the emerging market with resource nationalism gives only foreign firms financial or other types of damages. Thus, political risks are negatively associated with not local firm's performance, but foreign firm's performance.

*Proposition 1:* The political risk will be negatively related to MNC subsidiary's performance.

### 2.3 Affiliated firms and CSR strategy

Previous researches hypothesize that international diversification enhances shareholder value and performance of firms by exploiting specific assets, by increasing operating flexibility, and by holding globally diversified portfolios (Denis et al, 2002). The value of diversification is based on the internalization theory of synergy (Morck & Yeung, 1991). According to this theory, synergetic benefits stem from the existence of valuable information-based assets within the firm. Because these assets have increasing returns to scale and are difficult to sell, it is optimal for firms having information-based assets to internalize the markets for these assets. International diversification could be viewed as a process for bringing buyers and sellers of information-based assets within the same firm. Thus, international diversification increases value in the presence of substantial tangible and intangible assets.

International diversification could also increase value by creating the flexibility within the firm to respond to changes for relative prices and other institutional differences. That is, a multinational firm has the flexibility to shift production to the country in which production costs are lower, or shift distribution to the country in which market demand is higher. This statement is similar to Stein (1997)'s argument for investment decisions in industrially diversified firms. However, there are some negative aspects for international diversification. A globally diversified firm is more complex than a purely domestic firm. This complexity can bring high costs of coordinating corporate policies to firm. Harris et al. (1982) discussed costs of information asymmetry between corporate headquarters and multi-segment organizations. Also, Bodnar et al. (1999) hypothesized that the monitoring of managerial decision making can be more difficult in globally diversified firms.

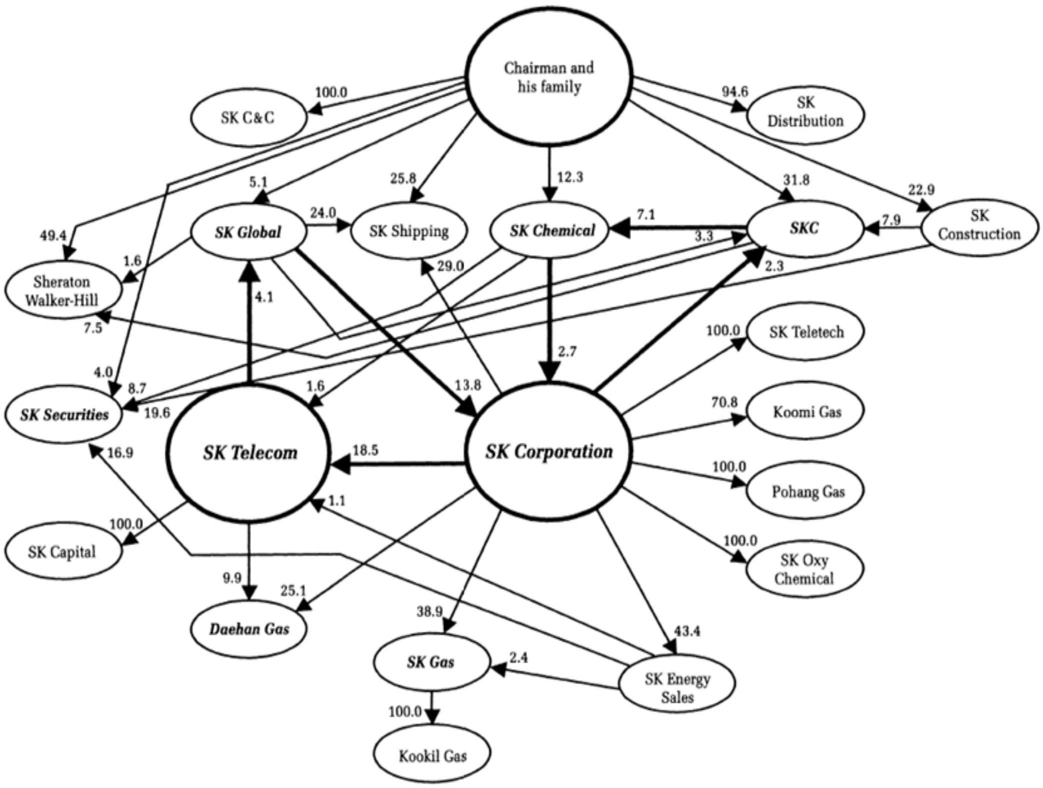
In this study, I focus on industrial diversification, not international diversification. Denis et al. (2002) classified firms by industry and market of a firm. Four types of firms that he suggested are single-segment domestic firms, multi-segment domestic firms, single-segment multinational firms, and multi-segment multinational firms. I pay attention to single-segment multinational firms and multi-segment multinational firms in this paper. Because domestic or multinational markets in which a firm operates are issues for interests of stakeholders, firm's performance, and etc. CSR strategy that I argue is related to industrial diversification. That means multi-segment in Denis et al.'s (2002) study. In addition, multi-segment is associated to multinational firms according to the result of his study. Thus, this research includes two types of firms.

Industry diversified firms could generate higher profits. This argument is related to the resource-based view of the firm (Schilling & Steensma, 2002). Because products and services produced within the same industry are related in their use of similar input factors and markets (Chen, 1996). A firm is seen as a bundle of tangible and intangible resources, which has the tendency to become disproportionate in relation to the existing level of production (Penrose, 1959). That is, some resources are usually in oversupply. He also suggested that faced with an excess of a particular resource, such as tacit knowledge and organizational process, a firm has an internal incentive to diversify to realize benefits from exploiting the excess resource. In this study, industry diversification through exploiting the extra resource is positively related to acquiring resources in the emerging markets. However, those resource acquisitions are generated by not industry diversification, but making full use of industry diversification through CSR strategy.

CSR means that a corporation should have social responsibility, as well as is doing business to pursue the returns or benefits. These activities are not necessary, however, required to have sustained competitive advantages in the long term. Porter & Kramer (2006) considered corporations' investment in local infrastructure as a strategic CSR. Also, Marquis et al. (2007) regarded creating a social infrastructure including economic development, housing, public safety, and local environmental efforts as a CSR. Corporations build the social infrastructure in poor countries as a CSR activity (Aslaksen & Synnestvedt, 2003). In this paper, I focus on supporting local business including infrastructures, technological transfers for local firms, and financial supports for local communities. These CSR activities could help MNCs to overcome the political risks in the emerging markets.

There would be some arguments for the assumption that affiliated firms with diversified industries implement CSR strategies more than unaffiliated firms in this research. McWilliams & Siegel (2001) addressed that a firm's level of CSR depends on its size, level of diversification, research and development, advertising, government sales, consumer income, labor market conditions, and stage in the industry life cycle. He suggested the positive relationship between the level of product differentiation and the provision of CSR properties.

In addition, Udayasankar (2008) addressed the U-shaped relationship CSR and firm size. The degree of CSR participation of large-sized firms is high. Also, those firms have some attributes such as high visibility, high resource access, and large scale of operations. The U-shaped relationship means that the degree of CSR participation of large or small-sized firms is higher than medium-sized firms. However, I assumed that small-sized firms are reluctant to explore resources in the emerging markets, since small-sized firms do not have enough capital or competitive advantages to expand their business abroad compared with large-medium sized firms. Thus, I limited foreign firms which enter emerging markets to large-medium sized firms except for too small-sized firms.




**<Figure 2>** The affiliated firm with diversified industries

Source: Chang, S. J. (2003). Ownership structure, expropriation, and performance of group-affiliated companies in Korea. *Academy of Management Journal*, 46(2): 238-253.

Figure 2 shows the Korean affiliated firm with diversified industries as a good example. The SK group is one of such affiliated firms, as well as a leading company in Korea (Chang, 2003). They have a variety of industrial fields involving chemical, construction, telecom, shipping, gas, energy, distribution, and etc. As noted earlier, this diversification can enhance the exploitation and exploration from the resource-based view. For example, we can compare SK energy with the Korea National Oil Corporation (KNOC) which enter the emerging markets to obtain oil, around the same time. SK energy can get support from SK construction or SK teletech to aid local community with building infrastructure like reads, buildings, or communication facilities which a local country needs. These CSR activities would help SK energy to gain the legitimacy and the trust with local government, local firms, and local community in the emerging markets. An organization is likely to gain the legitimacy for survival (Scott, 1995). On the other hand, the KNOC is limited to implement CSR activities since the KNOC is single industry firm. Thus, there would be difference between performance of unaffiliated firms and affiliated firms with diversified industries.

In reality, several governments have still supported the investment of foreign firms for the industry area in which local firms need advanced technology. That is, they discriminate between the foreign firms according to whether local governments and local firms need or not. Affiliated firms with diversified industries and greater financial resources could gain the legitimacy and trust-based relationship in the emerging market with high political uncertainty. On the basis of this discussion, I formulate the following proposition.

*Proposition 2a:* The negative relationship between political risk and MNC subsidiary's performance will be weaker for affiliated firms with diversified industries than unaffiliated firms.

*Proposition 2b:* The negative relationship between political risk and MNC subsidiary's performance will be weaker for affiliated firms with greater financial resource than unaffiliated firms.

### 2.4 Institutional change and cost-benefit in CSR strategy

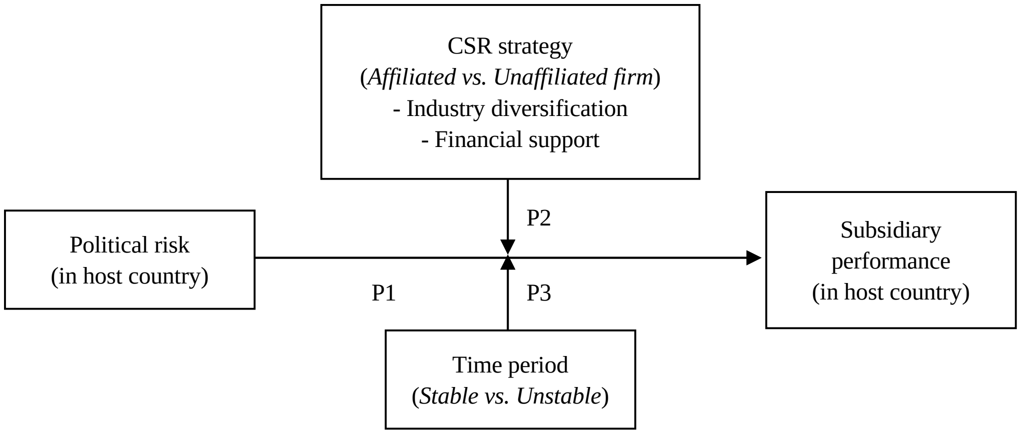
Neo-resource nationalism caused the institutional change in the emerging markets. Oliver (1992) suggested three general types of pressure toward deinstitutionalization. Three types of pressure are functional, political, and social pressure. First, functional pressure happens by performance problems associated with institutionalized practice. Second, political pressure is caused by shift in the interests and underlying power distributions. Third, social pressure is generated by differentiation of groups, heterogeneous divergent beliefs and practices, changes in laws or social expectations. In this study, I highlight the political pressure by government in the emerging markets. Institutional pressures, rather than strategic analysis of social issues and stakeholders, are guiding decision-making with respect to CSR (Husted & Allen, 2006). Namely, CSR is viewed as one of the strategies in order to overcome the political pressure in local markets.

However, CSR activities are accompanied with considerable costs at initial stage. Thus, foreign firms could not help considering the aspect of cost. How much managers should spend on CSR is a critical issue (McWilliams & Siegel, 2001). Also, they argue that CSR can be viewed as a form of investment. In this study, CSR is a form of investment to overcome the political risk in the emerging market in long term view.

When it comes to measuring performance, I focus on subsidiary's performance in the local markets in this research. We could divide the performance into direct and indirect aspects. For example, SK energy's performance is regarded as SK group's performance. The reason is that resource acquirement of SK energy in the emerging market is included in the assets of SK group. SK group can exploit those resources (which SK energy gained from local market) to other industries, markets, or new business. This is an indirect aspect. On the other hand, the subsidiary could generate the benefit from the local markets through business or survive without expropriation by the local governments and suffering from buyout by the local firms. This is regarded as direct aspect. Furthermore, the contracts with respect to CSR activities could provide MNCs with bargaining power, as well as legitimacy in the long term.

Thus, the initial performance of the affiliated firm implementing CSR activities is relatively less than unaffiliated firms due to the costs for CSR activities. That is, costs of CSR are more than the benefits in local markets. However, the benefits including financial profits or survival in local market may exceed the CSR costs over time when political risks become higher.

*Proposition 3:* The costs of affiliated firms will exceed the benefits at the initial stages, while the benefits of affiliated firms will exceed the costs over time when political risks become higher.




**<Figure 3>** Integrated theoretical framework

## 3. Conclusion

I suggested the impact of CSR strategy of MNCs on their subsidiaries' performance in the emerging markets. As I proposed, the CSR strategy would be effective to overcome the political problems during unstable period. To sum up, the political risks would be negatively related to MNC's performance (subsidiary performance in host country). Also, the negative relationship between political problems and MNC's performance may be weaker for affiliated firms with diversified industries or greater financial resource than unaffiliated firms. In terms of cost and benefit, the costs of affiliated firms would exceed the benefit during stable period (1990s), while the benefits of affiliated firms would exceed the costs over time when political risks are higher during unstable period (2000s).

These potential suggestions show the importance of CSR activities in the emerging market where political risks are high. Thus, the affiliated firms from Korea should continually keep and then promote the CSR strategy to compete MNCs from other foreign countries. Furthermore, affiliated firms have relative superiority for implementing the CSR strategy. The affiliated firms with diversified industries or greater financial resource from Korea have to cooperate and support the unaffiliated firms from Korea. The coexistence between the affiliated and unaffiliated firms would generate the synergy effect which brings the sustainable competitive advantage to each other in long term view. As global hyper competition has been accelerated after the emergence of neo-resource nationalism in the emerging markets, securing natural resources is becoming more and more important. The CSR strategy and cooperation can be the best effective solution to overcome the political problems than any other strategies such as joint venture, business agreements, and retaliatory acts (engaging in a counter attack) in the long term.

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## About the Authors

**Youngsam Cho** is working as an associate professor at the Department of Business Administration of Gyeongsang National University. He received his Ph.D. from the Business School at Korea University. His current research interests include leadership, entrepreneurship, employee outcomes, work-life balance, corporate social responsibility and etc.
E-mail address: yscho@gnu.ac.kr