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The institutional heterogeneity of Europe as a regional market

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Introduction

Europe, and in particular the European Union, has integrated both politically and economically over recent decades (see Philip, Chapter 15 in this volume). However, it remains a continent consisting of fifty sovereign states with their distinct institutional characteristics. This institutional heterogeneity can impose major challenges for firms entering or operating in different European locations (cf. Jain et al. 2016; Kim & Aguilera 2016). Indeed, researchers have demonstrated that, in general, the performance of international firms is dependent on the surrounding institutional conditions, and on their ability to adapt to different locations (e.g. Christmann et al. 1999; Makino et al. 2004; Chan et al. 2008). In this chapter, I discuss the institutional heterogeneity of Europe as a market area by building on complementary streams of literature on the subject. In so doing, I shall specify a related set of challenges for firms' international activity in Europe.

In addition to drawing on the growing body of research in the field of international business (e.g. Rugman & Verbeke 2004; Jackson & Deeg 2008; Peng et al. 2008; Schneider et al. 2010; Holmes et al. 2013; Kolk et al. 2014), I build on research in the fields of organizational sociology, economics, and political science. It is beyond the scope of a single review to capture the developments in these various bodies of literature, which display multiple theoretical angles and analytical approaches. However, the commonly agreed argument is that business organizations are always embedded within institutional contexts that both constrain and enable their activities. According to North (1990), for example, the formal and informal rules of the institutional environment provide a fundamental incentive structure for economic actors. Neo-institutional research in organization theory, for its part, has shown that at the organization level, the institutional environment can create specific pressures of legitimacy as well as related processes towards isomorphic behaviour as firms try to ensure their survival by aligning themselves with the environment (e.g. DiMaggio & Powell 1991; Scott 2008). However, research on institutional entrepreneurship (e.g. Battilana et al. 2009), institutional work (e.g. Lawrence et al. 2009), and institutional logics (e.g. Thornton et al. 2012) has indicated that organizations and individual actors do also have the capacity to induce changes to the prevailing institutional settings (cf. Lamberg & Pajunen 2010).

This chapter is constructed as follows. First of all, because the institutional infrastructure of a country may have considerable influence on the activities and performance of firms, I discuss how research on comparative institutional analysis (cf. Ahmadjian 2016; Morgan et al. 2010) has approached this topic, and how it has attempted to capture the socio-political heterogeneity of European countries. Second, I shall consider the features and implications of this heterogeneity from an organizational point of view, seeking to provide a more fine-grained understanding of how firms may evaluate appropriate locations for their activities within Europe. Third, I consider what the differences in European locations imply for multinational firms, not only in terms of maximizing profits, but also in their endeavours to fulfil the role of a good citizen in a given host country. Finally, I outline questions for future research.

The institutional diversity of European locations

Research on comparative institutional analysis (e.g. Ahmadjian 2016; Morgan et al. 2010) has explicitly addressed the institutional complexity of nation-states. This field of research also includes the impactful discussions on *Varieties of Capitalism* (Hall & Soskice 2001) and *National Business Systems* (Whitley 1999) approaches. Altogether, these accounts provide an appropriate starting point for considering the particularities and commonalities of Europe, with its patchwork of nation states, as a market area.

The Varieties of Capitalism (VoC) approach of Hall and Soskice (2001) emphasizes that the performance of firms is dependent on how they engage with other actors in a given political economy. The central questions involve how firms are able to raise finance, how wages and working conditions are regulated, how to ensure the necessary skills of employees, how to secure access to inter-firm inputs and technology, how market competition regarding the product is regulated, and how interfirm cooperation is arranged. On the basis of notable variations in these (institutional) domains of economic activity, two basic types of capitalist economies have been proposed, namely the *liberal market economy* (LME) and the *coordinated market economy* (CME). The core difference between these systems involves the dominant mechanism of *coordinatio*n. In the case of LMEs, such coordination is based on market mechanisms, whereas in the case of CMEs, the coordination is based on more strategic interactions with stakeholders.

The archetype of the LME is the United States, but European countries such as the United Kingdom and Ireland are also typically considered to be examples of LMEs (Hall & Gingerich 2009). According to Hall and Soskice (2001), in LME countries, the shareholding of large firms is dispersed, and access to external financing depends heavily on measurable criteria such as stock valuation models. Due to relatively weak levels of unionization and employment protection, the labour markets in LMEs are fluid, and wage setting occurs between employers and workers without strong external regulative coordination. This, in turn, creates incentives for workers to acquire general and transferable skills.

Although it is possible to identify LMEs in Europe, the continent has more examples of CMEs (for example the Nordic countries, Belgium, the Netherlands, Switzerland), with Germany providing an archetypal case (Hall and Gingerich 2009). In these European CMEs, the ownership of large firms is more heavily controlled by networks of cross-shareholding, with the employer and industry associations having had a pivotal role in the interfirm cooperation and governance structures of the nation as a whole. The role of the employer associations is strong in terms of coordinating wage setting and defining standards for industry-specific skills. These institutional characteristics require relatively stable interaction between different spheres of the economy and society, and may also promote the emergence of consensual decision making.

The VoC approach also includes the explicit statement that institutional conditions are often complementary, meaning that the enhancement of one institutional condition assists the provision of another. This complementarity can be one reason behind the greater extent of capitalistic models in Europe. In line with this, Whitley (1999) focused on dominant patterns of economic organization and control. He proposed the existence of six different types of national business systems (Fragmented, Coordinated industrial district, Compartmentalized, State organized, Collaborative, Highly coordinated). Empirical validation for this notion was provided by Hotho (2014), who showed that while these distinct business systems could be regarded as ideal types, examples closely approximating to them can be found in Europe. In addition to the above, open economies in Northern Europe, such as those of Denmark, Sweden, and Finland, seem to constitute a distinct Nordic business system (Amable 2003; Hotho 2014).

While the Nordic countries have not been immune to the financialization and competitive pressures that require a relatively flexible labour force, this increasing flexibility has been at least partly complemented by the high skills of employees, the high level of social protection, and at least a moderate level of employment protection. It appears that the distinct institutional environments in Nordic countries may still be supportive of knowledge-intensive business activities, even if transformations within these countries have brought them closer to the market-based model.

Currently, the CME model in continental Europe appears to be under pressure. In line with this, the importance of banks in the German financial system has weakened, and some elements of the shareholder-value model have strengthened relative to the previously dominant stakeholder orientation. This development can be seen as making Germany internally more heterogeneous (Jackson & Sorge 2012). However, since the financial crisis of 2008, there have been political tendencies working in favour of more regulated forms of capitalism. These may support the renewal of some elements that are typical of CMEs in continental Europe.

Currently, despite the fact that most European nation-states have continued to move in the direction of a liberal, market-based system, one can see opposing tendencies involving protectionist and nationalistic voices. These have taken the form of, in particular, strong public criticism of the European Union (as seen the Brexit referendum in the United Kingdom), resistance towards the Transatlantic Trade and Investment Partnership, and the increasing popularity of populist and even extreme right wing parties throughout Europe. These may have the potential to act as a brake on market liberalization. Indeed, from the economic point of view, a likely consequence of Brexit is that the amount of free trade in Europe will diminish, with a potentially negative effect on economic growth. From a political point of view, the claims presented by nationalistic populists may also push governmental decision makers to reconsider the appropriate form of capitalism in their respective countries.

How is the diversity of European locations important to firms and managers?

The institutional logics of interpretation

To gain a deeper understanding of what the heterogeneity of European locations means for specific types of economic activity, one must also consider the issue from the organizational and managerial point of view. The complexity of the institutional environment creates challenges for firms even in their home country contexts. However, understanding how shared norms and values constrain or enable organizational activities is critical when the firm enters new host countries (cf. Kim & Aguilera 2016; Marano et al. 2016; see also Cordeiro Chapter 5 in this volume). Researchers focused on neo-institutional organization theory have paid notable attention to consider this issue in general.

A core concept in this discussion has been that of institutional logics. Thornton and Ocasio (1999, p. 804) have defined these as 'the socially constructed, historical patterns of material practices, assumptions, values, beliefs, and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality'. Thus, by definition, if the managers of firms do not have any knowledge of the prevailing institutional logics, they can be largely adrift regarding how to interpret matters and behave in contextually bounded social situations. This may of course have critical influence on the success of their international operations.

With increasing European integration, there could exist certain institutional logics that are shared the entire European market area (McGuire et al. 2012; Philip Chapter 15 in this volume). However, the core features of institutional logics are that they are historically contingent, and that they operate at multiple levels of analysis (Thornton et al. 2012). This means that generally speaking, logics are culturally, politically, and cognitively embedded, and relatively slow to change. A firm that has always been embedded in a particular institutional context may take the prevailing institutional logics for granted, fitting its organizational routines and practices round those logics of the home country. As a result, if this firm tries to internationalize, it will almost inevitably face a host location that possesses its own, historically contingent, cultural and cognitive rules for social interaction. This new location may not provide a perfect fit with organizational routines and practices that have been unquestioningly reproduced in the home location of the firm. Similarly, if the founders of born global or born-European (cf. Suder 2011) firms do not have prior experience of the country in which they start their operations, they are likely to face the same situation, at least to some extent.

Recent accounts of institutional complexity (e.g. Greenwood et al. 2011) have emphasized that firms may encounter heterogeneity regarding institutional logics of action, even within a single location; and that this heterogeneity, while historically contingent, may not be stable over time. Thus, when one takes into account the institutional variety that exists in Europe, one can anticipate that even within the borders of a single nation-state, the management of institutional complexity may pose a real challenge for multinational and internationalizing firms.

Industry-level analyses of institutional conditions

For multinational firms, it is crucial to find an appropriate location for business activities. Correspondingly, it is important for nation states to attract investment from foreign firms. The institutional infrastructures of countries may have an important role in such investment decisions. Pajunen (2008) has shown the ability to attract foreign direct investment (FDI) does not depend on a single institutional factor, but rather on specific combinations of institutional conditions. Furthermore, even among a relative homogeneous set of European countries, there can be several paths to the same outcome. For example, if we consider countries located in Central and Eastern Europe, a country may improve its FDI attractiveness relative to its peers by ensuring political rights and civil liberties, political stability, and at least one of the following conditions: favourable taxation, a fair and independent judicial system, and property rights. Political instability is a strong deterrent to FDI. Moreover, among the nation states of Western Europe, corruption – combined with either inflexible labour regulation or an unfavourable taxation system – creates institutional conditions that make a country unattractive for FDI inflows.

Firms also need to understand how the institutional conditions of political economies specifically relate on the competitive forces prevailing in their industry. This can impel them to take a pragmatic, firm-based approach in seeking out an appropriate location for their business activities. Usually, this begins by evaluating the conditions within a country that may be critical for the industry in which the firm operates. A study by Pajunen and Airo (2013) sheds some light on this issue. The researchers focused on the location-specific conditions for a successful generic medicines industry within European countries. They found that even if the drivers of a firm's performance are always various, the generic medicine industry provides an example of an industry in which firm performance is typically explained by country-specific features. Here, one must bear in mind that generic medicine, by definition, is produced without patent protection (because the original patent has expired). This means that the type of regulative system in a given country is likely to have a fundamental effect on the success of the industry. The primary issue in this case is whether the country has established a reference price system. The industry may also benefit from an institutional environment that supports small-scale improvements in the production processes. In fact, this condition appears to be a typical feature in CMEs overall (cf. Hall & Soskice 2001). Furthermore, the level of public health care expenditure, and the demographics of the population, constitute important factors influencing the demand for generic medicines. Altogether, European countries are far from homogeneous regarding all these conditions.

In line with the view that institutional conditions are often complementary, no single location-specific condition on its own is necessary for the presence or absence of a high-performance generic medicine industry (Pajunen & Airo 2013). Finding a suitable country for the industry thus requires an examination of the interdependent and complementary effects of the various institutional conditions. This means, first of all, that the causal relationships between country-specific conditions and industry performance can be complex. Secondly, there can be different configurations of conditions that lead to the same outcome.

The findings of Pajunen and Airo (2013) indicate that there are two sufficient configurations of conditions supporting the existence of a high-performance industry. First of all, a favourable environment for the generic medicine industry includes a country location with CME characteristics, a high level of public health care expenditure, and price regulation via a reference price system. The Nordic countries, such as Denmark and Iceland, are prime examples of this type of location. As an alternative path, a clearly different set of Southern European countries provide an advantageous environment for this industry. The conditions in this case comprise a CME, a price reference system, a high proportion of elderly people, and a relatively low national income. Thus, the political economy of CMEs and the regulative environment manifested as a price reference system are important country-specific conditions that in part explain the success of a generic medicine industry. Nevertheless, these are not, as separate conditions, sufficient to guarantee the success of the firms.

Altogether, earlier accounts on comparative institutional analysis have provided theoretical understanding of how country-related conditions enable or restrict business activities, and have also offered more practical, industry-related implications concerning the institutional conditions that matter for specific types of business. This kind of analysis is important for a multinational company that is evaluating appropriate country locations for its operations, whether these are related to innovative products and services, or to bulk products. Altogether, while increasing EU integration has worked to harmonize institutional structures among the member countries, it is likely that the attractiveness and market potential of different European locations varies with the industry in question.

Societal norms and values from an ethical point of view

Beyond consideration of the market potential provided by different European locations, firms need to consider the *societal legitimacy* of their activities. Basically, this is related to how far firms take note of ethical and responsibility-related issues reflecting societal norms and values. While one might assume that Europe is a relatively homogeneous area in terms of practices related to *corporate social responsibility* (CSR), previous research has indicated that this may not be the case (Aguilera et al. 2007; Matten & Moon 2008). In fact, according to a study by Gjølberg (2009), there are striking differences between sixteen European nations regarding the CSR activity of the companies they host.

Using a CSR index, Gjølberg (2009) found that relative to the size of the economy, countries such as Switzerland, Norway, Finland, Sweden, and Denmark are the most over-represented in terms of CSR; in contrast, Greece, Italy, and Ireland are strongly under-represented in this dimension. As a point of comparison, the USA scores negatively in all the different variations of the index. This finding is interesting, given that the USA is often seen as the originator of CSR practices. One explanation for this result relates to the fact that the indicators within the index do not include philanthropy (Gjølberg, 2009), which has been a traditional manifestation of CSR in the USA.

In considering the implications of heterogeneity in CSR, it is crucial to understand that CSR takes on different meanings in different institutional environments (Aguilera et al. 2007; Matten & Moon 2008; Brammer et al. 2012). The common definitions of CSR emphasize the centrality of voluntary activity that 'further[s] some social good, beyond the interests of the firm and that which is required by law' (McWilliams & Siegel 2001, p. 117). Indeed, seeing CSR as something that goes beyond legal requirements allow different types of activities to be included under the label of CSR in different institutional settings (cf. Brammer et al. 2012). Matten and Moon (2008) recognize this issue. Building on notions of national business systems and the VoC approach, they argue that there are two distinct manifestations of CSR, which can be termed *explicit* and *implicit*.

Explicit CSR encompasses openly-declared voluntary programs and strategies on the part of corporations. Activities in this domain, relying on corporate discretion, can be driven by instrumental, relational, and moral motivations (cf. Aguilera et al. 2007). They typically combine social and business interests. Sometimes explicit and instrumentally motivated CSR can be fully subjugated to the strategic goals of the corporation. Implicit CSR, for its part, refers to the ways in which corporations are embedded in the institutional environment of the society in question. Basically, the values, norms, and rules of society (both informal and formal) impose mandatory and customary requirements for companies regarding how far they should consider the claims of different stakeholders in a collective manner, rather than in relation purely to the firm (Matten & Moon 2008). Seen in this light, the role of corporations is to follow and adapt to the institutionally established practices of legitimate and responsible business activity.

Explicit and implicit CSR also lead to different forms of linguistic usage related to CSR. According to Matten and Moon (2008), firms practising explicit CSR use the language of CSR in stakeholder communication. However, this is not typical in the case of firms practising implicit CSR. Despite this, the institutional embeddedness of implicit CSR does not indicate that corporations are less active in their responsibility-related behaviour. In fact, as shown by Gjølberg (2009), it is likely that the opposite is the case.

Regarding the basic types of capitalistic economies in Europe, the findings of Jackson and Apostolakou (2010) suggest that companies within LME countries follow explicit CSR practices as a substitute for formal institutions. In CMEs, for their part, the institutionalized and societally regulated practices related to the social responsibilities of companies do not seem to require the same kind of explicit CSR activity. The findings of Kang and Moon (2012) also show that in LMEs, the manifestations of CSR are predominantly competitive, complementing shareholder-value thinking.

On the basis of the studies mentioned above, I would argue that in doing business in different locations in Europe, companies need to consider their views on what is legitimate and ethically acceptable corporate behaviour, relative to the institutional frameworks of the countries in which they operate. This can be a particularly important issue if a firm is extending its operations from one type of national business system to another. Here, one must also bear in mind that the heterogeneity of European institutional environments ranges beyond the 'ideal' types of political economy discussed above. Moreover, there are likely to be industry-specific concerns related to the appropriate forms of CSR to be followed (cf. Jackson & Apostolakou 2010). Because of this, we can assume that the variety of ethical standards across (and within) country contexts will bring considerations of appropriate CSR practices strongly to the fore, wherever the firm has business activities (cf. Mantere et al. 2009). This is underlined by recent empirical research indicating that MNCs are likely to encounter a notable level of institutional complexity related to CSR practices in different countries (Marano & Kostova 2016).

Altogether, there can also be possible downsides in the institutional awareness of MNCs. In particular, it can lead to a situation identified by Surroca et al. (2013), in which firms use internationalization as an instrument to transfer their socially irresponsible practices to the locations of their subsidiaries, in order to 'window-dress' their behaviours within their headquarter countries. Europe cannot be seen immune to this issue.

Conclusion

The development of the European Union has to a large extent unified economic and political rules in Europe. Thus, from the perspective of non-European – and even European firms – the continent exemplifies several attributes of a regional market. In this chapter, however, I have shown that Europe is still institutionally heterogeneous. This variety among nation-states generates both notable opportunities and challenges for multinational and internationalizing firms. Indeed, it is important to be aware that the 'psychic distance paradox' suggested by O'Grady and Lane (1996) seems to be valid also from a pan-European point of view. One could go so far as to say that institutional heterogeneity is a core idiosyncrasy of Europe as a regional market area.

Although multidisciplinary literature regarding this topic has advanced during recent years, the discussion in this chapter indicates a clear need for continuing research. In particular, I consider that there is a need for a better understanding of the multi-level effects and relationship dynamics between different socio-political systems and interpretation systems at firm level. I shall conclude by considering some questions related to these issues.

First of all, more empirical research is needed on how the different forms of capitalism and national business systems in Europe influence actual corporate behaviour. For example, we may consider that in Germany or in Nordic countries, the relatively strong heritage of stakeholder involvement, the central role of bank-based financing, and the underlying welfare ideology have created systemic institutional logics supporting long-term development and investment activity on the part of firms. This course has been followed as an alternative to corporate strategies for the maximization of short-term earnings and shareholder value – aspects which are emphasized in typical liberal market economies (cf. Aspara et al. 2014). However, we do not have much knowledge (cf. Kolk et al. 2014) of whether and to what extent current market liberalization and financialization developments within the European economies may have actually changed the institutional logics influencing managerial behaviour.

On a related topic, while our understanding of institutional logics has accumulated during recent years, we do not know much about how firms are able to modify attention structures and cognitive frames. This is especially the case when firms enter foreign locations and face local actors that follow certain logics of behaviour based on certain cultural and material practices of that country. It would be reasonable to assume that individuals and organizations in new host locations will tend to act and to give meaning to their social reality primarily on the basis of the logics learned in their home country. In line with this, previous research has underlined the importance of home country institutions in the location choices made by firms (e.g. Kolk et al. 2014). Here one can point to an example providing anecdotal evidence: the stock of investments from Sweden to (institutionally close) Finland is more than five times higher than the stock of investments from Sweden to France, even if the French economy is ten times larger than the economy of Finland.

At the same time, at the firm level, one can also predict that those firms that have successfully managed institutional complexity in their home locations will be at an advantage in terms of learning about and adapting to the institutional logics prevailing in foreign locations. Thus, further research is needed on the cognitive capabilities of managers in terms of dealing with institutional complexity. I consider that examination of this issue could also advance the capabilities perspective on internationalization (see e.g. Sapienza et al. 2006).

Furthermore, research at the firm level could examine how firms have localized their CSR and ethical practices in Europe, and how the measures taken may have influenced their legitimacy in different countries, and among their customers. Here, it would be of interest to examine how the variety of implicit and explicit CSR practices in Europe has created cognitive challenges for the managers of multinational firms. Studies in this domain would also consider how managers orchestrate their responsibility activities, and how they seek to communicate with different stakeholders concerning these activities.

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