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Research on Institutional Distance and Outward Direct Investment

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Abstract. The institutional quality of home country and host country influences not only the amount but also the performance in outward direct investment. This paper analyzed the institutional quality in host country and home country respectively, as well as the relation between institutional distance and outward direct investment. This paper also studied the impact of formal and informal institution in outward direct investment. The issues such as positive and negative distance in institutional distance; the level of institutional quality; the dynamic institutional distance; the interaction between institution and other factors are also discussed in this paper. Measures such as policy coordination between host country and home country, knowledge of policy and regulation in host countries, localization strategy and social responsibility could help mitigate institutional distance risk in outward direct investment.

Introduction

Institution quality of home countries and host countries plays an important role in outward direct investment. Institutional distance is an important factor in location choice of outward direct investment. Institutional factors also have considerable influence in macro level risks in outward direct investment. Outsider disadvantage indicate that multinational enterprises tend to invest in host countries with similar institutional with home countries. Escapism outward direct investment of emerging market multinational enterprises are more likely to invest in host countries with higher institutional quality, which could benefit from sound legal system, contract enforcement, intellectual property protection. The home country institution attribute to foreign affiliation of the firms, while host country institution quality has an impact on mode of entry. This paper analyzes the institutional distance and outward direct investment in the following aspects: the second part of the paper analyzes institution quality in host country and home country respectively; the third part studies the impact of formal institutions and formal institutions on outward direct investment; while the fourth and the last part concludes and provides some policy implications.

Institution Quality and Outward Direct Investment

Institution Quality in Host Countries

The positive institutional quality attracts foreign direct investment. Strategic capital in host countries attracts foreign direct investment, while the accessibility and cost of obtaining strategic resource is closely connected with institution in host countries. The institutional factors, such as width and depth of financial market, the legal system, the degree of protection of foreign investment, have an impact on the scale and direction of technological spillovers in outward direct investment. Transaction cost and contract cost resulted from incomplete market environment, as well as weak property protection, would enhance the inclination of corporations to outward investment so as to operate in a better business environment overseas. The convenience of investment could also be considered in location choice of outward direct investment. The troublesome procedure could hinder overseas investors, while the easiness of investment procedure would facilitate outward direct investment. Negative influence of host country corruption could hinder foreign direct investment. However, in the case of multinational enterprises from some emerging economies, though in competitive disadvantage in advanced economies, has similar institution quality with other emerging economies, would have the ability and experience to cope with corruption in host countries. A myth of positive relation of weak institution and direct investment from emerging economy has been extensively discussed in academic research, which indicates that corporations from home countries with problematic institution tends to invest in host countries with weak institution. Totally reversed conclusion could be drawn if control variables such as natural resources are considered in the scenario. Risk of expropriation associated with lack of consistency and transparency of regulation would increase uncertainty in foreign investors. Natural resources and other strategic resources could be complementary to weak institutions in host countries, and attract investment overseas to obtain the resource. The policy carried out by developing countries to attract foreign investment, which usually indicate tax reduction and other financial and non-financial benefit, could increase inflow of foreign direct investment. Financial system plays an important role in macro economy. Higher degree of financial stability and financial deepening in host countries would attract foreign investors. However, financial risk seeking behavior could be found in investors from overseas, in order to harvest a higher investment return. The number of financial institutions, the scale of financial transaction and the completeness of financial system in host countries, are influential factors in outward direct investment. R & D overseas provides multinational enterprises from emerging market a strategic advantage, the level of innovation and policy support in host countries attribute to decision making in outward direct investment. Research centers in advanced economies established by corporations from emerging market, and technology seeking mergers and acquisitions are increasing. The outward direct investment destinations of Chinese firms are emerging economies in Asia, which has an advantage of near institutional distance as well as geographical distance. The developed countries with sound legal system, copyright protection, fair market environment and established financial system attract direct investment from multinational enterprises from developing countries.

Institution Quality in Home Countries

Compared to host country factors, home country factors are equally important yet less emphasized in the studies concerning outward foreign direct investment. Escapist outward direct investment is motivated by unfair market environment, distorted taxation system, excessive regulations, defected legal system and other negative institutional factors in home countries. Regulations in home countries increase outward direct investment from enterprises which are seeking more business opportunity and easier market environment. Problems in home country regulations, such as lack of consistency and transparency in regulations in home countries, protectionism, corruption, week intellectual property protection, are driven factors for outward direct investment. Taxation in home country is also an important factor in decision making of outward direct investment for enterprises. Distorted tax system in home countries would lead to market seeking outward direct investment. Inequality in taxation levied on private sector in some emerging economies would lead to similar tax avoidance outward direct investment. Tax havens are amongst the most popular destinations that attract foreign direct investment. Higher taxation levied on private sector or inappropriate taxation system motivates firms with business advantage and policy disadvantage to invest overseas, so as to compete in a better market environment. While enterprises from private sector are driven to operate overseas by defected home country institution, the state-owned enterprises are motivated by different reasons. Policies facilitate outward direct investment are implemented in many emerging economies. Various policy measures, such as tax reduction and financial support, as well as policy support for domestic firms to obtain strategic resources overseas, the establishment of specialized agencies to promote outward direct investment, increases participation in outward direct investment. Policy driven outward direct investment might result in low efficiency, less than expected performance and risks in investment, for the firms are more concerned with harvesting policy dividend than realizing overseas growth potential of the corporation. Seek economic freedom is one of the crucial purposes in outward direct investment from emerging market multinational enterprises. Market distortion in home country would increase foreign affiliations of domestic firms. The distortion of market price, unequal competition environment, the restricted access of financial support propelled enterprises in private sectors in developing countries to seek a better operating environment overseas. The policy implemented by home countries to facilitate outward direct investment has a significant impact on decision making of enterprises to operate overseas.

Institution Distance and Outward Direct Investment

Formal Institutions

Rule of law, regulations, taxations and other policies are considered formal institution, as well as the market quality, financial system and the overall business environment, are considered formal institution. The distance in formal institution between home country and host country reflects in decision making, mode of entry and performance of outward direct investment. The differences in the legal system lead to outsider disadvantage in outward direct investment. Less than favorable market, defect institutions in regulation and law, uncertainty in enforcement of commercial contract, similar operation environment in some emerging host countries, prepared multinational enterprises to invest in similar host countries. Weak institution equipped multinational enterprises from emerging market with the ability to deal with corruption, inconsistency of policy or lack of transparency in merger and acquisition biddings. Some research indicate that from the perspective of risk management, investment performance and profitability, multinational enterprises from emerging market excelled over firms from developed countries. Near institution distance provides comparative advantage for enterprises from home countries with similar weak institution. The corporate governance structure of multinational enterprises from emerging market tends to be more adaptable to host countries with weak institution. The dynamic institutional distance, the changing environment of regulation and rule of law in host country and home country, the institution reform, the inward foreign direct investment as a learning opportunity for multinational firms from emerging market to invest overseas, the experience of inward foreign direct investment and export help the emerging market enterprises to cope with formal and informal institutions in other countries. Institution distance has a negative impact on mutual foreign direct investment flows. The direction of the distance influences the direction of the investment. The negative institution distance, which means more favorable institution in host country attracts more outward direct investment than positive institution distance, which means better institution in home country. The recognition of institution of host countries by managers from home countries is negatively related to institutional distance. The inability to understand and adapt to unfamiliar environment in host countries result in high information cost and communication cost, and increased difficulties in human resource management, marketing, negotiation with suppliers, and regulation compliance. Mutual political relations, such as the signing of bilateral investment treaties and free trade agreement would have a positive effect in outward direct investment. The formal institution distance between home country and host country, could affect not only the amount of investment, but also the performance of outward foreign direct investment. Generally speaking, outward direct investment could benefit from host countries with better institution than home countries. However, discrimination of developed counties to emerging economies could indicate a different scenario. Multinational enterprises from developing countries are likely to pay more in mergers and acquisitions in developing countries, while the premium is paid for such discrimination.

Informal Institutions

The social belief, values, ethics, way of thinking, understanding and behavior of local residence, are considered informal institution. Informal institution contributes to an equally important part as formal institutions in investment environment for multinational enterprises in outward direct investment. In addition to the legal, regulatory and economical institution, the social element of institution influences mode of business activity of organizations and individuals, which in turn attribute to performance and uncertainty in outward direct investment. The experiences acquired from international trade and foreign direct investment equipped multinational enterprises from emerging market with the capability to operate overseas, and help mitigate outsiders’ disadvantage. Informal institution should be analyzed in due diligence in outward direct investment decision making.

Commercial rules and custom, though not part of the legal system, plays a crucial part in economic activities, which indicate that foreign investors should adapt accordingly in organization structure and way of conducting business in host countries. The institution distance could lead to coordination difficulty in multinational enterprises, and problems in corporate governance. The common custom in business practice varies in different countries. To adapt to a new business model, and new way of operate in a foreign country could be challenging. Communication difficulty and language barrier attribute to uncertainty in post cross-border merger and acquisition. Language and cultural differences, if not be dealt smoothly, could result in human resource risk, low efficiency in the newly established foreign affiliation, and poor overseas investment performance. The language similarity between home country and host country attributes to higher level outward direct investment flow, and more successful performance. The value and moral code interacted with human resource management. Social network and ideology has an impact on supply and demand, marketing strategy, business negotiation and other aspect of outward direct investment. Cultural recognition between home country and host country may ease tension between foreign investor and local employees and customers. Social capital provided by immigrated ethnic groups, which help mitigate difficulty in communication and acceptance, could facilitate outward direct investment. Chinese immigrants in host countries facilitate investment of corporations from China. While the number of foreign students from host countries is positively related with outward direct investment.

Conclusions and Policy Implications

Outward direct investment is affected by institutional quality. The institutional quality of home country and host country influences not only the amount but also the performance in outward direct investment. This paper analyzed the institutional quality in host country and home country respectively, as well as the relation between institutional distance and outward direct investment. This paper also studied the impact of formal and informal institution in outward direct investment. The issues such as positive and negative distance in institutional distance; the higher institutional quality and similar relatively lower level of institutional quality; the changing institution, which indicate dynamic institutional distance; the interaction between institution and other factors such as natural resource, is also discussed in this paper. Measures could be taken to mitigate the institutional gap, and lower institutional uncertainty in outward direct investment. Dynamic institutional distance could be filled by mutual policy cooperation at country level. Specific risk management methods could be adopted for different host countries. The corporations could equip themselves with compliance department with expertise in legal, regulatory, policy and financial knowledge in host countries. Localization strategy and social responsibility in host countries would help mitigate informal institutional uncertainty.

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