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Escapism FDI from developed economies: The role of regulatory context and corporate taxation

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ABSTRACT

In this paper, we extend the conceptualisation of escapism Foreign Direct Investment (FDI) holding for emerging economies to developed economies that face specific institutional failures, such as weak or incomplete regulations, along with high taxation. We combine this literature with the recent development of Dunning's eclectic paradigm, which includes institutional aspects regarding location factors. We argue that in developed economies with problematic regulations and high taxation, sound institutions and lower tax rates abroad are extremely significant for domestic firms' internationalisation. A central result regards the moderating effect of host regulatory quality on taxation, which highlights the crucial role of institutions for firms originating in developed economies that lack sound institutions. Additionally, the results challenge the available theorising and evidence on the moderating role of institutions in the prior experience of a firm at a location. We instead provide evidence that once firms establish a subsidiary abroad, they acquire substantial knowledge about the host institutional environment, which translates into an Ot advantage, providing an additional motive for further expansion. This work uses a unique database of the total population of Greek MNEs – released for the first time – for an extended time period, 2001–2010. The results could be generalised to similar developed economies facing analogous regulatory failures and high taxation, such as the southern European Union countries, as well as even for northern European Union countries, such as Germany, according to Bundesbank's report.

1. Introduction

This paper investigates the strategic behaviour for internationalisation of developed market multinational enterprises (MNEs) in response to home market institutional obstacles emphasising escape Foreign Direct Investment (FDI), which is defined as the outward FDI of firms to overcome competitive disadvantages resulting from their home country problematic regulatory contexts or a bad home country image regarding firm competitiveness (Cuervo-Cazurra & Ramamurti, 2014). While escape FDI is a relatively well-known phenomenon among emerging market firms – although still under-investigated (JIBS, 2014; Witt & Lewin, 2007) – we argue that such escapist strategies can also arise among developed economies, particularly in situations in which firms face relatively poor home country institutional environments, including high taxation. We build our arguments by integrating insights from the growing literature on emerging markets' OFDI as a means to counteract the competitive disadvantages resulting from home country 'institutional voids' (Cuervo-Cazurra & Genc, 2008; Liang, Lu, & Wang, 2012; Luo & Tung, 2007; Witt & Lewin, 2007; Yamakawa, Peng, & Deeds, 2008) with the more recent development of the OLI paradigm, which encapsulates institutional aspects (Dunning & Lundan, 2008). The OLI paradigm is a suitable theoretical formulation that allows us to jointly test for ownership and locational advantages of firms' internationalisation, enriching our understanding of the relative significance of these two sets of determinants and helping us to clarify how interactions between the two promote escapism motives.

The growing significance of OFDI from emerging economies has led many authors to research the motivations of this phenomenon (Buckley et al., 2007; Deng, 2009; Kang & Jiang, 2012; Wang, Hong, Kafouros, & Boateng, 2012; Wu & Chen, 2014), emphasising escape FDI due to institutional weaknesses and voids relative to developed economies (Gammeltoft, Pradhan, & Goldstein, 2010). Although this line of research has grown rapidly, no studies to date have considered the possibility of such escape motives for developed economies. A developed economy is characterised by high gross domestic product and per capita income, a high level of industrialisation, a large amount of widespread

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infrastructure and a high general standard of living (IMF, 2016).[1] In contrast, emerging economies have some characteristics of a developed market but do not meet the standards to be classified as developed. Such countries are considered to fall within a transitional phase between developing and developed status (Jain, 2006), and they face economic and institutional transformations (Newman, 2000). Although developed economies are generally characterised by better institutions than emerging economies (Gammeltoft et al., 2010), it is not necessary the case for all developed countries. Instead, firms from developed markets could be subject to similar institutional voids and pressures as firms from emerging markets. Hence, there is a gap in the related literature regarding our understanding of escapist internationalisation motives and strategies in developed economies. The aim of this paper is to fill this gap by *extending the argument of escapist FDI to developed economies* that face institutional weaknesses or failures propelling firms to flee.

Our empirical context is Greece. Greece, Italy, Portugal and Spain constitute the southern European Union region, where the consequences of the crisis have become most salient and where governmental efforts to overcome the crisis have generated deep institutional changes (Manasse & Katsikas, 2018). International reports have pointed to the chronic institutional deficiencies of Greece,[2] while the tax system and the improvement of its overall performance have long been on the agendas of different political parties and have constituted a priority in memoranda adopted by Greece for fiscal consolidation (European Commission, 2015). Surprisingly, as early as 1997, the Bundesbank pointed to "high regulatory density" in Germany (Deutsche Bundesbank, 1997: 76), emphasising factors such as taxes and other stringent regulatory conditions (such as labour markets) that drive German firms to escape the institutional constraints of the country by investing abroad. The relative lack of research on OFDI as an escape response from developed nations thus stands in contrast with the above evidence.

This paper contributes to the literature in several manners. First, as mentioned above, it expands on existing internationalisation theory by combining theoretical predictions regarding escapist FDI from emerging economies with MNEs from developed countries. Second, we build this framework within the OLI paradigm on the grounds of Stoian and Filippaios' view (2008) that OLI is context specific; we thus formulate our arguments based on particular conditions prevailing in some developed economies that cause investors to internationalise, namely, the regulatory context and taxation. Third, this paper shows that, when both institutions and taxation are detrimental to home economic activities, hence causing investors to seek such characteristics abroad, they might be willing to overlook higher tax rates if the local institutional context is well developed. Fourth, we extend the current views of internationalisation by explaining how prior existence in a host location can be considered a transaction type ownership (Ot) advantage that can further enhance the effects of institutional conditions on escapist FDI motives, rather than mediate them, in contrast with previous evidence. Fifth, this work uses a ten-year (2001–2010) firm-level dataset consisting of the total population of Greek MNEs from all sectors that invest overseas. This difference contrasts with available studies in the literature that used national aggregate statistics (Wang et al., 2012) or a limited number of firms. The study was performed for the purpose of the robustness of disaggregated wide, and it opens the floor to further research to capture potential differential effects of firms' internationalisation strategies. Finally, we offer several recommendations for managers and policy makers emerging from our findings.

The remainder of the paper is organised as follows. We first discuss the theoretical framework and develop our hypotheses. Section 3 describes the incorporated variables and the model specifications. Section 4 provides the sample description and the methodology used, while in Section 5, we discuss our empirical results. Finally, Section 6 concludes the study and provides managerial and government recommendations.

2. Theoretical framework and hypotheses

Dunning's eclectic paradigm (1981) provides a holistic approach to the study of MNEs' activities abroad by integrating ownership, location, and internalisation advantages (OLI). The OLI framework combines the competitive advantages of firms (ownership advantages) and the comparative advantage of nations (location advantages) to explain production and the subsequent growth of MNE operations (Dunning & Robson, 1987; Tolentino, 2001). Although highly criticised[3] on the grounds of its generality, and hence its limited ability to identify the behaviours of specific enterprises, it continues to be the most influential paradigm that facilitates specific questions posed by theorists (Cantwell & Narula, 2001). Dunning and Lundan (2008) extended the determinants of FDI in terms of locational components of the eclectic paradigm, including policy-induced effects generated by policy intervention and institutions. Consequently, they recognised the significant role of the institutional context on MNEs' decision-making processes. The majority of empirical papers that use the eclectic paradigm address only location advantages, however, due to ownership data scarcity.[4]

Stoian and Filippaios (2008) argued that the OLI paradigm should rather be seen as context specific, rather than a generally applicable framework irrespective of firms, regions or countries, industries or value-added activities. Its applicability is likely to depend on the motivations for FDI (Dunning, 2001), and it can be used as a means of determining which theories and which level of analysis are most appropriate to any given set of circumstances (Cantwell & Narula, 2001). We adopt this notion here and therefore formulate our own OLI model within the context of MNEs originating in developed economies, which nevertheless face institutional voids and high corporate taxation. Greece is such a country and constitutes our empirical context. The country is besieged by low competitiveness, an unfavourable business environment (Pelagidis, 2010; Böwer, Michou, & Ungerer, 2014), political corruption, weak or bad institutions (Theocharis and Van Deth (2013) and failure of tax system performance (Kaplanoglou & Rapanos, 2011), among the most obvious issues. Relevant reports have stated that tax rates in Greece in all categories feature among the highest in Europe (PwC, 2016). The above facts point to two particular elements: a weak or problematic regulative environment and high taxation. Relevant evidence from Masuch et al. (2016) has shown that, over the past 15 years, not only Greece but also many of the early European Union countries have registered worsening of institutions, with the strongest drops in Greece, Italy and Spain. Additionally, Gropp & Kostial (2000) analysed the inflows and outflows of OECD countries depending on corporate tax burden. The evidence was striking, suggesting that outflows from higher corporate taxation economies are much greater relative to the remaining OECD countries. The above shape the context-specific framework of the OLI paradigm that we investigate in this paper to better understand internationalisation motives for firms operating in developed countries with institutional caveats and high taxation.

The mainstream theory of internationalisation explains firms'

[1] Moreover, in these economies, the service sector provides more wealth than the industrial sector.

[2] The OECD Regulation Database, the World Economic Forum competitiveness survey, the World Bank "Doing Business" and Governance Indicators and European Commission estimates, to name a few

[3] Dunning has acknowledged the framework's limitations; however, these limitations are beyond our study's scope. For some of the criticisms, one might consult Cantwell and Narula (2001); Dunning (2001); Dunning et al. (2007), and Tolentino (2001).

[4] Entry modes are beyond the scope of this study, which investigates FDI motives abroad.

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