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The effects of institutional distance on FDI inflow: General environmental institutions (GEI) versus minority investor protection institutions (MIP)

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ABSTRACT

Existing research suggests that foreign direct investment (FDI) flows into countries with good institutional infrastructure. We distinguish between general environmental institutions (GEI) that promote societal interests at large, and minority investor protection (MIP) institutions that promote the interests of a specific group, and argue that these types of institutions affect international investments differently. We tested this hypothesis by examining the effects of institutional distance on international M&A activities of US firms during 1981–2008. We found that better GEI in the host country attracts inflowing FDI while better MIP may discourage it, because of the perception that it reduces the potential gain an acquiring firm can earn from an international acquisition in that country.

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1. Introduction

International operations produce benefits for a firm because of oligopolistic or resource capabilities that can be deployed to exploit imperfections in the international market. These benefits are derived from reduced transaction costs and the creation of internal markets (Buckley & Casson, 1979; Caves, 1971; Williamson, 1975), or from utilizing and/or acquiring corporate resources and capabilities necessary for international operations (Barney, 1991; Penrose, 1959). Countering these benefits of international operations are the costs of information, monitoring and control as well as trade barriers, which all relate to the concept of "distance." Since international corporate investment involves establishing an operational facility at a distant location – separated not only by geographical distance but also by cultural and institutional distances – it follows that the extent and nature of these distances should influence a firm's incentives for investing abroad, other things being equal.

North (1990, 1994) was among the first to emphasize the importance of institutions, beyond culture, arguing that economic growth and performance are critically dependent on the efficacy of institutions. He defined institutions as formal rules and informal constraints that set the "rules of the game." In Dunning's (1981, 1988) OLI paradigm, a main location (L) variable is institutional distance, which allows for the interdependence between the firm and national institutions on both micro and macro levels. (Dunning & Lundan, 2008a). In international contexts, institutional distance is the extent of institutional dissimilarity between institutions in the home and host countries (Kostova, 1999). Using international firm-level data, La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1997) and La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1998) examined the impact of law on firms' performance, providing evidence that legal tradition and institutions have major impacts on financial development and corporate performance, but not vice versa. This result is consistent with North (1993) who argued that institutions influence economic variables even though the specifics of institutions differ. Xu and Shenkar (2002) presented conceptual ideas about the role of institutional distance in international corporate investments but no empirical evidence.

An increasing amount of literature on global finance and governance recognizes the role of international mergers and acquisitions (M&A) as a vehicle for the international convergence of corporate governance systems.[1] However, legal tradition, and

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[1] See Bris and Cabolis (2008), Chari et al. (2010), Dinc and Erel (2010), Ferreira et al. (2010), Moeller and Schlingemann (2005), and Rossi and Volpin (2004).

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social and public institutions are more deeply rooted in a society than corporate governance systems, such as board structure or corporate control. Legal tradition and institutions are now recognized to be a deep, underlying factor that drives the economic performance of nations and firms. Nonetheless, since La Porta et al. (1998), little work has been done on how institutions influence international corporate investment behavior, and whether divergent typologies of legal, social and public institutions affect international corporate investments differently. Multinational corporations (MNC) adjust their strategy and structure based on the "uncertainty and complexity" of the environment, just as they do for institutional quality, which makes the characteristics of countries increasingly important (Cantwell, Dunning, & Lundan, 2010).

In this study, we examined the effect of institutional distance of foreign direct investment (FDI) flowing into a host country by using international M&A data for US firms. We analyzed a vast dataset consisting of 7,492 cases of international M&A by US firms that invested in 38 countries from 1981 through 2008. We began with the idea that two distinct types of institutional distance are relevant for FDI. The first type includes institutions that have impact on the entire society, or on all constituents and all investors equally, such as political institutions, the rule of law, contract enforcement, and similar. We refer to this class of institution as "general environmental institutions (GEI)." The second type of institution protects a specific type or group of investors such as minority shareholders or debt holders rather than the society at large. We refer to this class of institutions as "minority investor protection (MIP)" institutions. Our contention is that the distinction between GEI and MIP is essential for understanding the effect of institutions on FDI. We expected that the institutional distance in GEI would be positively associated with FDI inflow when the host country improves these institutions, while distance in MIP is negatively associated with FDI inflow. We found that the effects of institutional distance on international acquisitions, as measured by the percentage of equity ownership of local firms sought by US firms (FDI inflow to the host country, for improving institutional infrastructure), was positive and significant, but only when GEI variables are included.[2] This is consistent with the finding by Globerman and Shapiro (2003) that countries that fail to achieve a minimum threshold of effective institutional governance are unlikely to receive much FDI inflow. However, when we include MIP institutions, the impact on the FDI inflows is negative and significant. Although this is surprising in light of the popular notion that regards institutional developments, without distinction, as positive, it is consistent with real option theory as applied to institutional development. A high level of local investor protection is indicative of a lower potential for flexibility and profitability for inward international acquisitions by multinational firms. If *domestic* equity investors and creditors are already well protected, the potential gains for an *international* acquirer who introduces superior management and governance in the host country will be smaller. Thus if specific MIP institutional infrastructure is already in place in the host country, it may reduce the attractiveness of that country for international corporate investors. To the extent that the valuation of the host country, prior to committing to investment, is driven by the value of potential growth, this explanation is consistent with the real option perspective as a motive for international investments (Kogut, 1991; Tong, Reuer, & Peng, 2008).

In conclusion, an acquiring firm may prefer a host country that has a general institutional infrastructure, but not the one where a high level of investor protection because of the possibility that it protects existing local investors at the expense of future international corporate investors. We interpret this to be consistent with a real option valuation for investor protection existing in the host country prior to international M&A. This concept of FDI inflow is new, and supports the idea that the attractiveness and pull of incoming FDI depends on the nature of local institutional development, not its level. This contrasts with the general practice in empirical international business research, which assumes institutional distance is a single, homogeneous variable that influences corporate international investments.

The remainder of the paper is organized as follows. Section 2 discusses institutional theory and develops our empirical hypotheses. Section 3 describes the data and methodology, while section 4 presents empirical results. Section 5 discusses the results concludes the paper.

2. Institutional theory and hypotheses

Institutions are "the rules of the game in a society [that] structure incentives in human exchange [and] affect the performance of economies over time" (North, 1990). In contrast to the "old institutionalism" that focused on describing the organization as an economic environment and how the arrangement of power influences control of the economic system (Engerman & Sokoloff, 2008; Samuels, 1984, 1987), the "new institutionalism" is motivated by the neoclassical foundation of rationality, optimization and equilibrium. New institutionalism opens up and expands the theory of the firm in areas like the organization and operation of the corporation (Samuels, 1995). This is an attempt to extend the range of neoclassical theory by accounting for institutional factors such as property rights and governance structures, including the role of nonmarket arrangements in influencing economic, financial and business behavior. However, unlike old institutionalism, new institutionalism is not an attempt to replace standard neoclassical economic theory (Parto, 2005). Rather it views MNCs as a "coordinated system of domestic and cross-border value-added activities" (Dunning & Lundan, 2008a, p. 125) that use FDIs to maximize profits and growth.

North (1990) introduced the notion of *institutional* "path dependence." Path dependence recognizes that increasing returns to institutions can lead to "lock in" of a particular institutional arrangement that emerged for unique historical reasons (Boettke, Coyne, & Leeson, 2008). Sachs (2000) suggests that the barriers to evolutionary social change are so powerful that a fundamental institutional change can only be the result of an external shock, not internal evolution. If so, institutions that are successful in one country cannot easily be transferred to another country with the same result, implying that institutions are sticky (Boettke, Coyne, Leeson, & Sautet, 2005; Boettke et al., 2008). The conclusion drawn from this literature supports the notion that institutions are important exogenous variables for explaining outcomes in different environments.

The extant literature on the typologies of institutions focuses on formal (e.g., law and regulations) versus informal (e.g. self-imposed codes of conduct) institutions.[3] Formal rules need to map onto the existing informal institutions in order to be successful for economic development (Boettke et al., 2008). According to Greif (2006), the key characteristics of institutions are exogenous to individuals and "reflect intentional or unintentional human actions." It is important to remember that even without direct government involvement, individuals are able to form trading coalitions to enforce certain economic behaviors. For example,

[2] As a result of a dramatic increase in the last three decades, the international M&As have become a principal form of FDIs (Weber and Tarba, 2010; Gomes et al., 2011).

[3] For a detailed example of formal vs. informal institutions, see Dunning and Lundan (2008b).

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