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# The impact of home-country institutions and competition on firm profitability☆

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ABSTRACT

Firm profitability depends on firm characteristics, industry structure and home-country institutions. Firm profitability is negatively associated with institutional quality. The effect of entry regulation on profitability runs through competition, while the effect of legal and political institutions only partially runs through competition.

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## 1. Introduction

Scholars in international business and management have shown interest in how location of firms and country factors affect firm profitability. Many prior studies focus on the relevance of firm and industry determinants of performance. Recent literature suggests that country-level institutional characteristics are also important in explaining variation in corporate profitability. McGahan and Victer (2010) investigate the role of home-country effects in explaining variation in profitability for a large sample of firms from various countries. Although they find that home-country effects are more important to domestic firms than to multinational firms, they still detect significant home-country influences even for highly international firms. Makino, Isobe, and Chan (2004) document the importance of host-country effects on the performance of a sample of Japanese firms. Building on this literature, our study tackles the following research questions: Do home-country institutions adversely or positively affect firm profitability? And, which are the mechanisms through which home-country institutions influence firm profitability?

We focus on a country's entry regulation, its legal environment and its political involvement in the economy. We expect to find a negative relation between the strength of these institutional features and firm profitability. Theory suggests that stronger entry regulations erode economic profits by fostering competition and allowing for low barriers of entry. Sound political institutions and high law enforcement (high legal quality) should also be associated with higher competition as they demote anticompetitive conduct, increase the probability of detecting collusion and reduce the benefits of collusion. In turn, we predict higher competition to lead to lower firm profitability. It is important to note that our reference to firm profitability does not equal firm performance. Our measure of firm profitability does not capture firm market value, stock returns, firm growth or growth opportunities. We primarily aim at measuring the economic rents firms are able to extract.

Competition is considered to be a key determinant of the extent to which firms are able to extract (monopolistic) rents (Nickell, 1996). Competitive intensity, however, is also the product of legislation in factor markets determined at the country-level (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Yet, few studies take the degree of competition experienced by companies explicitly into account. Hence, it is still an empirical question as to what extent firm profitability is the result of the interplay between competition and home-country institutions. In this study we investigate empirically whether profitability of firms varies systematically across countries and whether competition and home-country institutions explain this heterogeneity. In our main identification analysis we explicitly model competition as a

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function of institutions and distinguish between the effect of institutions through competition and their effect on firm profitability over and above competition.

Our identification analysis and empirical tests allow for detecting any potential effects of home-country institutions on firm profitability *through* the level of competition and through channels *other* than competition. Doing business in environments with weak legal enforcement and high expropriation risk by the state (i.e. low institutional quality) is likely to make managers only to take on riskier projects with higher expected future profits. Subsidies, capital injections and other forms of government support may increase domestic firm profitability. We expect this to be the case in exactly those places where political connections are the rule rather than the exception and where politicians and statesmen are powerful. Nevertheless, from a theoretical point of view the most straightforward effect of home-country institutions on firm profitability is through their impact on the competitiveness of a firm's business environment. Therefore, we consider it an open question whether there is any measurable additional influence of institutions on corporate profitability, other than its influence through competition. Our identification analysis is aimed to shed light on this issue.

To test our predictions, we employ a large sample of 10,755 manufacturing firms (68,535 firm-year observations) from 53 countries all over the world. Two features of our sample selection deserve special attention: its international scale and its focus on manufacturing firms. We deliberately choose firms from a large number of countries (from all over the world) to enhance the external validity of our findings. Our research question is to what extent country-specific features affect profitability. Examining this question requires us to focus on a large international sample with many countries represented. Without sufficient international variation in the sample we would be unable to investigate this relation in a reliable and accurate fashion, as institutional variation would be limited and conclusions would only hold for a small portion of the world. We focus on manufacturing firms to have a more homogenous sample of firms across countries. By focusing solely on manufacturing firms, we already implicitly control for many firm characteristics influencing firm profitability due to differences in business type. Finally, our main analyses occur at the country-level, with one single observation per country. As an alternative specification, we employ a firm-specific model to test our predictions.

Our findings show a strong association between firm profitability and the home-country institutional environment. In line with prior research and theory we find that home-country competition relates negatively with firm profitability, controlling for economic growth and various firm characteristics and industry effects. We also find that a country's level of competition is significantly determined by its legal and political institutions, as well as by its entry regulation. Our most intriguing result is that home-country institutions have an important effect on firm profitability through competition, but also over and above, or *given*, the level of competition. Finally, institutions affect firm profitability in both open and closed economies, although the effects are stronger in the latter group of countries.

Our study makes several contributions to the literature. First, very few studies have explicitly investigated whether a country's institutional environment is related to firm profitability, despite this being a highly relevant question for international business academics. It is important to gain insights into how country factors affect firm profits. McGahan and Victer (2010) and Makino et al. (2004) are two studies that come close to investigating this issue. However, the variance decomposition analyses of McGahan and Victer (2010) do not allow investigating different *types* of institutions, and their results are silent on the *direction* of the relation between institutions and profitability. Makino et al. (2004) from their side only consider the performance of Japanese multinational firms, limiting the generalizability of their results. Our study contributes to this literature by investigating both the nature and magnitude of the relation between country factors and firm profitability. Our main argument for predicting a negative relation between institutional strength and firm profitability is because stronger institutions are seen as inhibiting competition. In turn, competition affects how easily firms can earn economic rents. We find evidence consistent with this prediction.

Second, our methodology explicitly takes into account the different relations between institutions, competition and profitability. The methodology we rely upon has been applied successfully to investigate determinants of macroeconomic (country) performance (e.g. Hall & Jones, 1999). However, to the best of our knowledge, it has not yet been used in the context of microeconomic (firm) performance. Our main analyses occur at the country-level. Additional analyses are done at the firm-level in which we investigate the same relationships to complement and further refine our findings. The two main objectives of our methodology is to provide evidence on the nature and magnitude of the relation between firm profitability, competition and institutions and to test whether institutions influence firm profitability mainly through competition or not. A vast literature has decomposed variance of firm performance into firm, industry and country effects (Bowman & Helfat, 2001; Makino et al., 2004; McGahan & Porter, 1997, 2002; McGahan & Victer, 2010). While this method is particularly well suited to identify potential firm-, industry- and country-effects (as well as interacting effects) on firm performance, it does not allow the researcher to differentiate between the effect of the home country *through* competition and their effect *over and above* competition. Yet, it is interesting and highly relevant for international business scholars to have insights into how particular aspects of a firm's environment affect its profits. We contribute to this literature by testing whether the influences of country institutions on firm profitability occur primarily because of a differential competitive environment, or whether there is still a significant relation detectable when holding constant competition. Our paper is the first to explicitly test this highly relevant issue. Our results indicate that there are indeed important effects of institutions on firm profitability that do not only flow through competition. Until now, this result has been undocumented in the literature.

Third, extending international business research (Brouthers, 1998; Chacar, Newburry, & Vissa, 2010; McGahan & Victer, 2010) we provide further evidence on the important role of country-specific features, embodied by our institutional measures, in explaining cross-sectional variation in firm profitability. The main message from our study and these previous papers is that, when explaining economic characteristics of firms in an international setting, researchers need to take into account the effect of country differences. Finally, we want to emphasize that our sample is substantially larger than in prior studies in this research area, which enhances the external validity of our findings. To our knowledge, we are the first study in international business to investigate the relation between firm profitability and institutions for such a large sample of countries and companies.

The remainder of the paper is organized as follows. In the next section we review existing literature and formulate hypotheses. In Section 3, we provide details on our sample selection and define our relevant variables. In Section 4, we elaborate on our methodology. Section 5 shows and discusses our empirical results. Section 6 concludes the study.

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