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Words vs. actions: International variation in the propensity to fulfil investment pledges in China

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ABSTRACT

We examine whether companies from certain countries are more likely to fulfil investment pledges. Using data on contracted and utilized FDI in China, we find that firms fulfil an average of 59% of their pledges within two years. The propensity to fulfil pledges is lower for firms from countries with greater uncertainty avoidance, power distance, and egalitarianism; higher if the source country is more traditional; and is unaffected by popular attitudes towards China. Prior literature has found that these cultural characteristics are associated with higher levels of utilized FDI. We extend this to show that announcements of planned corporate activity may be more reliable for firms from countries with certain cultures.

1. Introduction

Firms often announce large investments publicly well before actual capital flows occur. As a result of this time lag, the monetary values of proposed and actual investments may differ non-trivially due to information received in the interim, or the belief that an investor is not bound by prior pledges. For example, we find that in China just 59% of all investment pledges are fulfilled in the same or following calendar years. Economic transactions involve elements of trust (Arrow, 1972) and trust can increase levels of foreign direct investment (FDI) and trade (Guiso, Sapienza, & Zingales, 2004). Trust is considered to be one of many elements of culture, and cultural characteristics such as egalitarianism also increase FDI flows (Siegel, Licht, & Schwartz, 2011, 2012). Thus, we examine whether the propensity to fulfil investment pledges is related to national culture using data on contracted and utilized FDI flows into China.[2]

The propensity of investors to pre-announce investment plans has been studied previously through a focus on the *speed* with which investment pledges would be fulfilled. We explore a new dimension of this question by focusing on the *degree* to which investment pledges are fulfilled. Thus, we build upon the growing body of knowledge that national culture affects corporate activity

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[2] Since all investments examined in this paper are in China, the phrases "national culture", "home country culture", and cultural distance are used interchangeably. We note that this is in slight contrast to some of the papers we reference that use data for cross-border activities world-wide, and thus do not have a common base country.

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through the managerial decision-making channels (Li, Griffin, Yue, & Zhao, 2013) and FDI (Siegel et al., 2011, 2012). Roughly two-thirds of cross-border FDI occurs via mergers and acquisitions (Head & Ries, 2008), and the volume of cross-border mergers is inversely related to cultural distance between source and host countries (Ahern, Daminelli, & Fracassi, 2015). Corporations from countries with higher levels of uncertainty avoidance hold more cash for precautionary purposes and make lower levels of corporate expenditures, acquisitions, and repurchases (Chen, Dou, Rhee, Truong, & Veeraraghavan, 2015). These arguments suggest that cultural characteristics might systematically affect the propensity of investors from a country to fulfil investment pledges.

By examining only firms engaging in cross-border investments, we situate our analysis of the impact of culture on corporate activity in the context of FDI. The impact of national culture on bilateral FDI inflows has been studied previously in two different ways. First, the literature on FDI determinants has focused on common cultural values (Siegel et al., 2011, 2012), and on the impact of coethnic trade and investment networks (Huang, Jin, & Qian, 2013; Tong, 2005). Second, the corporate finance literature has examined how national culture affects corporate actions in general, oftentimes proxied by managerial decisions (e.g., Chen et al., 2015). Both literatures share a commonality in that they examine how national characteristics affect observed levels of investment.

We look one step earlier at pledged levels of investment to ascertain if ex post observed levels of investment (i.e., utilized FDI) are systematically related to ex ante pledged investment levels (i.e., contracted FDI). China is the only country that receives significant FDI inflows and systematically collects and, until 2005, released data on pledged levels of FDI.[3] We therefore examine this question in the China context as there is variation in the levels of contracted and utilized FDI received from different source countries. Moreover, throughout this period China was one of the largest recipients of FDI worldwide. We are thus able to reconcile the two literatures by proposing an explanation for how national culture affects bilateral FDI flows: culture creates variation in the degree to which firms are expected to fulfil promises made previously.

The national culture of the source country may have different effects on the levels of pledged and actual FDI, particularly in the case of China. First, firms from countries with higher levels of uncertainty avoidance have higher levels of corporate cash holding due to precautionary motivation (Chen et al., 2015). Similarly, when the source country has a higher level of uncertainty avoidance, firms are significantly less likely to undertake risky actions (Li et al., 2013). As a result these firms may find it easier in general to make investments due to a reduced need to acquire external funding and yet have a preference to invest in better understood opportunities that may present reduced levels of risk through the presence of fewer unknowns. This would be consistent with the finding that firms are more likely to invest in locations that are more culturally familiar (Du, Lu, & Tao, 2008, 2012) and where local partners are considered more trustworthy (Ang, Cheng, & Wu, 2015). These arguments suggest that home country cultural characteristics should have similar effects on both contracted and utilized FDI. This effect may be moderated, however, by the presence of shared linguistic ties (e.g., local usage of Chinese characters) or by popular sentiment towards China as China's role in the world economy has changed markedly, in reality and in perception, over the period studied herein.

Second, FDI flows reflect national aggregation of data generated by firm level activities. Whether firms make and fulfil investment pledges reflects managerial decision-making and is related to, but may be separate from, how the firm finances growth through usage of the external and internal capital markets. Glaser, Lopez-de-Silanes, and Sautner (2013) show that multinational conglomerates do not always invest as planned due to managerial hubris that generates investment inefficiencies. The Glaser et al. findings complement and extend the earlier findings of Wurgler (2000) that there is substantial variation in the efficiency of capital allocation across industries within countries.

Third, the Chinese data on contracted and utilized FDI represent national level analogues to the firm level data studied by Glaser et al. (2013). China requires many foreign investors to receive government approval for investments, and the government has thus long compiled data on contracted, or pledged, FDI. Utilized FDI data are verifiable as they represent cross-border capital flows and would therefore be visible on the national accounts of the host and source countries. In addition, until December 2005, the Ministry of Commerce reported monthly on the levels of contracted FDI. As the central Chinese government granted policy incentives to provinces based on the levels of pledged investments, it is possible that the announced values of contracted FDI were artificially inflated in response to local government officials' incentives (US-China Business Council, 2006). Alternatively, it is possible that firms from certain source countries were more inclined to inflate investment pledges in order to extract greater rents from local government officials.

A source country's national culture might affect the willingness of firms to even consider investments in a particular country or the likelihood that a project might receive government approval. This is consistent with the prior findings that companies from source countries that are more culturally distant from China are more likely to invest only in parts of China with stronger economic institutions (Ang et al., 2015; Du et al., 2008, 2012). In order to examine whether cultural characteristics affect the propensity to fulfil pledged investments, we conduct empirical tests using a gravity model of international trade to examine the impact of source country culture upon FDI. Since firms value quick fulfilment of investment pledges (Hawk, Pacheco-de-Almeida, & Yeung, 2013), the propensity of firms from a country to fulfil their investment pledges can be proxied by use of the UC ratio, as developed by Hornstein (2011), and renamed the commitment ratio herein. The commitment ratio is the ratio of the level of utilized FDI in a year to the average value of contracted FDI announced in the current and prior years.

While the average country-year level of contracted FDI was $186 mn and the average country-year level of utilized FDI was $131 mn, on average just 59% of all investment pledges were fulfilled within two calendar years. We find that the commitment ratio is lower when the source country has greater uncertainty avoidance, although this effect is mitigated by the extent of past FDI into

[3] To the best of our knowledge, the only other countries that regularly collect and release some data on pledged FDI are Cambodia, India, Laos, the Philippines, Thailand, and Vietnam.

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