

# Formal institutional risks and firm performance in emerging market economies

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*Abstract—the aim of this study is to empirically reconcile the impact of formal aspects of host countries’ institutional risks on the performance of multinational firms in emerging economies.*

**Keywords—** Host’s Institutional Environment, Firm Performance, Formal Institutional Risks, Private property rights protection and contract enforcement, Corruption, Quality of public administration or bureaucracy.

## I. INTRODUCTION

Since firms’ strategic decisions and management are undertaken in such institutional environments, the quality of that environment could influence firms’ performance. Therefore, understanding the host-countries’ underlying institutional environment becomes an important ingredient for successful market entry and performance. Consequently, the importance of underlying institutions in influencing firm performance has been one of the main focuses and significance in IB research (Peng et al., 2008; Henisz and Swaminathan, 2008; Griffith, Cavusgil and Xu, 2008). This study specifically extends and fill the gaps in its focus that include crucial formal institutional dimensions, such as corruption, competencies of bureaucracy, stabilities of the government (i.e. political risks), property rights protection and enforcement, and regulations on the business activities, credits and labour, as well as the overall institutional environment that are critical for foreign firms and assess its impacts on firm performance (e.g. degree of profitability).

## II. HYPOTHESIS AND GRAPHICAL ILLUSTRATION

Based on evidences in the literature, the relationship between institutions and firm’s performance is hypothesized as follow:

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Since high qualities or low risks of formal institutions represent low transaction cost environment, firms operating in such context are likely to perform better than those operating in the weak (high risks) formal institutional environment. This is because firms incur lower transaction cost as security and protection of property rights are better ensured. The profitability and long-term prospects of the investments would be impaired in high risk formal institutional setting or context since firms cannot reap the benefits/profit from its

investments due to high transformational and transaction costs (e.g. expropriation of the private business profit, corruption, incompetent and cumbersome bureaucracies, excessive regulations on business activities). The recent case in point was shown by Sufian and Habibullah (2010), and Wu (2013), that institutional development (i.e. legislative institutions and economic freedom) increases the performance of firms in emerging economies. We would expect:

**HI:** Better formal institutional environment (i.e. lower formal institutional risks) positively influences the performance of the domestic and foreign firms.

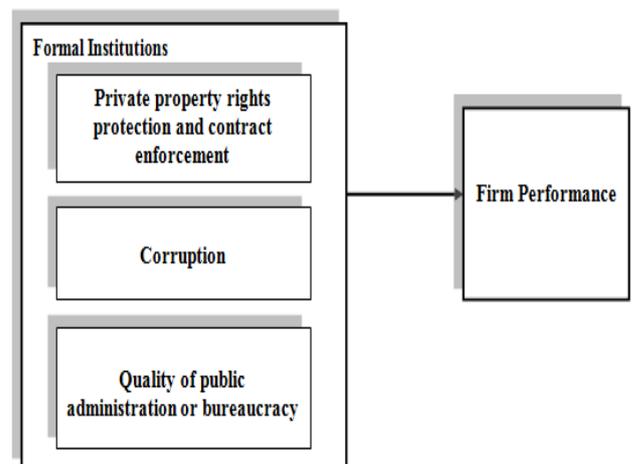


Fig 1. Study Framework

## III. LITERATURE REVIEW

Institutions are well-known to have broad meaning. However, the well accepted definition and framework is that of Nobel Laureate Douglas North (1981, 1990). He devised an institutional framework that take into account both formal and inform aspects of institutional infrastructure. Though North’s (1981, 1990) institutional framework emphasize on broad institutions; the formal institutions aspects entered on two important sets of formal institution namely “contracting institutions” and “property rights institutions” reflecting the dilemma of the state’s function. According to Acemoglu and Johnson (2005), these core formal institutions reflect in North’s (1981, p. 20-27) “contract theory” and “predatory theory” of the state, respectively. North’s (1981) contracting theory of the state concerns legal frameworks that are provided by the state and its various institutions to

facilitate and support private contracts so to reduce transaction cost in the economic transactions and exchanges (Acemoglu and Johnson, 2005). Thus, better quality of this set of institutions ensuring private contracts, from both sides of the contract, are well observed and enforced would support well-functioning market. Weak institutions enforcing contracts would encourage opportunistic behaviors among the contractual parties, hence high transaction cost, as each side engages in extra cost to ensure the contract is observed, e.g. hire guards, monitoring agencies. In contrary, North's (1981) predatory theory of state stressed on the facts that state also functions as tool by those controlling it to transfer the resources from one particular base to another (Acemoglu and Johnson, 2005). This predatory view on the role of state reflects property right institutions. Weak set of these institutions reflect low/unconstraint powerful elites and politicians which tend to redistribute the resources to them or their group. This may works from a high tax, corruption and rent seeking activities to outright expropriation of private property such as nationalization without compensation, stealing and theft.

Some scholars for instance found that they are important determinant of firm venturing and partnership with local partners in that environment (Meschi and Riccio, 2008) and not only that informal institutions can also complement the formal aspects of institutions when they are non-existence or weak quality. For instance in weak formal institutions (low institutional constraints to ensure elites and powerful groups or individual do not expropriates others' private property and that contract is not well enforced), then trust among business partners and business culture in a particular countries and language similarities may also play important role in the success and failure of business venture and performance. Particularly, culture were shown to determine work managers' leadership style (Byrne and Bradley, 2007), performance of firms' strategic-alliance (Li et al., 2012), quality of bank earning (Kanagaretnam, Lim, and Lobo, 2011), and firm's work orientation (Gomez-Mejia, 1984), among others. Kirkman et al. (2006) and Venaik and Brewer (2010) provide a good survey on the issue of culture and its influence on international business.

Despite the important of private property rights and contracting institutions, international business literature mainly focus on one aspect of institutions namely political risks. Beside political risk, recent studies also show the important role of cultural and language diversities of the host countries in influencing international business particularly the entry and performance of firms into foreign markets (López-Duarte and Vidal-Suárez, 2010; Meschi and Riccio, 2008; Lessard and Lucea, 2009; Keillor, Wilkinson, and Owens, 2005; Rothaermel, Kotha, and Steensma, 2006; Sanchez-Peinado and Pla-Barber, 2006; Slangen and van Tulder, 2009; Wan and Hoskisson, 2003; Miller, 1992; Haley, 2003). In what follows, empirical studies on the effects of

formal on firm entry mode and performance are reviewed.

Institutions formal dimensions are the underlying factors that determines socio-political and economic fabrics of a country. The important role of institutions in explaining the failure and success of business has recently been receiving great attention among international business studies (Henisz and Swaminathan, 2008; and the special issue on institutions in Journal of International Business Studies (JIBS); Griffith, Cavusgil, and Xu, 2008).

At the macro- or country-level, it has been a well-accepted view that institutions directly explain why some countries are poor while others are rich. However, evidence at micro-level, how formal institutions matter in supporting markets in providing conducive environment for entry and exit of firms and entrepreneurs and more importantly the performance of firms in that environment are far lag behind. Although above recent studies in the international business literature suggest that both formal and informal institutions matter for firm entry but less evidence on firm performance. Further, these existing evidence mainly centered on one aspect of host countries' formal institutional risk namely political risks and a commonly focus on culture. Furthermore, such evidences are either based on developed countries or a mixed sample between developed and developing countries, an exclusive focus on emerging economies has so far been limited. Moreover, only few recent studies have looked at interaction effects between formal institutions but focus on firm entry (López-Duarte and Vidal-Suárez, 2010; Jiménez, 2010). To fill these gaps on institutions and firm performance, this proposed thesis seeks to provide a comparative study on formal and informal institutions focusing on both aggregate and selected disaggregate core aspects of formal institutions is relied upon to assess their impacts on firm performance in emerging economies.

#### IV. METHODOLOGY AND DATA

This section describes the variables and their measurement as well as the sources of the data. The firm's data is collected from World Bank's Enterprise Survey (WBES). Since 2002, World Bank has been conducting firm-level surveys through a face-to-face interviews with top general managers, managing directors, accounting managers, human resource managers, and business owners for over 130,000 companies in 135 countries across the globe. Each country was surveyed every three to four years with arund 1,200 to 1,800 interviews were conducted for large economies (e.g. China), 360 interviews for medium size economies (e.g. Bangladesh, Sri Lanka), and 150 interviews for small economies (e.g. Latvia, Estonia). There are two part in WBES process. The first part is answered by top general managers, managing directors and business owners focused on issues of business environment, investment

climates, and business strategy. The second part, to be answered by accounting managers or personal managers, focuses on investments flows, products cost, firm performance and workforce statistics of the company.

In measuring the quality of embedded underlying institutions in a country, scholars rely on opinion based subjective measures. Accordingly in this study, the measures of qualities of formal and informal institutions are collected from sources mentioned above. Measures of the quality of formal institutions are from both firm-level and country-level data while that of informal institutions are only available at the country level. Firm level data means that each firm has a particular value on each variable, while country level data means each country has one particular value for each variable. In what follow, throughout this study, for variable that are only available at country level mean all firms for that country take only one (and the same) value. Thus, the variation in the data comes from both countries and firms (i.e. cross-country and -firm variations). These institutional measures usually come in the form of scores along a particular scale, for example 0 to 10, or 0 to 100. These scores reflect opinions of the business community through surveys, and the experts on the extend of quality of the institutions.

Take for instance, quality of legal institutions. WBES measures the quality of legal institutions through the survey questions on managers: Whether they are confident that the judicial system will enforce their contractual and property rights in business disputes. The level of confidence is measured in six increasing categories (1. Fully disagree; 2. Disagree in most cases; 3. Tend to disagree; 4. Tend to agree; 5. Agree in most cases; 6. Fully agree). This rating will reflect the quality of the legal institutions that ensure the protection of property rights and enforcing contracts. Thus, it is clear that bigger value of this index reflect better quality of legal institutions.

Similarly is the case for countrywide level of corruption (and the rest of institutional measures). ICRG views corruption as a reflection of institutional structure that allows people to assume position through patronage rather than ability. The most common form of corruption met directly by businesses is financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans. More seriously, corruption in the form of excessive patronage, nepotism, job reservations, ‘favor-for-favors’, secret party funding, and suspiciously close ties between politics and business. ICRG’ staffs collect, analyse and assess these information and convert into the score that reflect the degree of corruption exist in the countries. Low corruption means high quality institution or low institutional risks, ensuring meritocracy system allowing people to assume position based on their ability and talent. Similarly the case of the rest of institutional indicators is that higher score reflects high quality institutions. Table 3.2 provides detailed definition and sources on these variables.

For formal institutions, this study focuses on overall qualities and selected aspects or dimensions that

**Table 1 List of countries and total number of firms**

Country	Number of Firms	Year	Country	Number of Firms	Year
Bangladesh	1001	2002	Slovenia	223	2005
Brazil	1642	2003	Poland	975	2005
China	2400	2003	Ukraine	594	2005
Indonesia	713	2003	Hungary	610	2005
Pakistan	965	2002	Czech Republic	343	2005
Philippines	716	2003	Romania	600	2005
Sri Lanka	452	2004	Bulgaria	300	2005
South Africa	603	2003	Latvia	205	2005
Egypt	977	2004	Lithuania	205	2005
Senegal	262	2003	Estonia	219	2005
Morocco	850	2004	Russia	601	2005
Malaysia	902	2002	Turkey	1323	2005
Thailand	1385	2004	South Korea	598	2005
Vietnam	1150	2005	India	2286	2006
Mongolia	195	2004			
Argentina	1063	2006			
Colombia	1000	2006			
Chile	1017	2006			
Ecuador	658	2006			
Mexico	1480	2006			
Panama	604	2006			
Peru	632	2006			
Uruguay	621	2006			
Venezuela	500	2006			
Jordan	503	2006			

particularly relevant for businesses. The quality of formal institutions is measured both at firm and country levels. The overall institutions come from both ICRG and EF, and are country level measures. As mentioned in the preceding section, ICRG aggregate measure of overall quality of institutions of a country is the sum of 12 sub-components namely government stability, socioeconomic condition, investment profile, internal and external conflicts, corruption, military in politics, religion in politics, law and order, ethnic tensions, democratic accountability, and bureaucratic quality. This index range from 0 to 100, with the larger number means better quality. This index is standard in political economy literature (Knack and Keefer, 1993; Acemoglu et al., 2001, Hall and Jones, 1999, among many others). EF reflects the quality of institutions ensuring the freedom of economic exchange. The EF measure is also an aggregate measure taken from Heritage Foundation and Wall Street Journal. It is the sum of 10 components namely business freedom, trade freedom, monetary freedom, government size/spending, fiscal freedom, property rights, investment freedom, financial freedom, freedom from corruption, and labour freedom. This index range from 0 to 100, with the larger number means better quality. This index has been referred to in studies on firm performance (see for example Yaser et al., 2011, among others). Both are referred in this study because they are the most commonly used index of the quality of institutions in the literature.

**Table .2A Correlation Matrix**

	PD	UA	IND	MAS	LTO
Power distance (PD)	1				
Uncertainty avoidance (UA)	<b>0.6442</b>	1			
Individualism (IND)	0.2322	0.3777	1		
Masculinity (MAS)	0.1520	-	<b>0.5433</b>	1	
Long-term orientation (LTO)	0.3433	<b>0.5919</b>	-	0.1146	1

**Table .2B Principle Component Factor Analysis**

	Hofstede Cultural Dimensions			
	Eigen value	Difference	Proportion	Cumulative
Factor 1	<b>2.26865</b>	0.77901	<b>0.4537</b>	<b>0.4537</b>
Factor 2	<b>1.48964</b>	0.83204	<b>0.2979</b>	<b>0.7517</b>
Factor 3	0.65760	0.34302	0.1315	0.8832
Factor 4	0.31457	0.04503	0.0629	0.9461
Factor 5	0.26955	-	0.0539	1.0000

Source: Own calculation. Number of observation = 14071.

**Table .2C Factor analysis**

	Factor loading after Rotation	
	Factor 1	Factor 2
Power distance (PD)	<b>0.7984</b>	0.0502
Uncertainty avoidance (UA)	<b>-0.9048</b>	0.1012
Individualism (IND)	-0.3734	<b>0.8372</b>
Masculinity (MAS)	0.2026	<b>0.9096</b>
Long-term orientation (LTO)	<b>0.7618</b>	-0.0186

Source: Factors are extracted using Principle Component Analysis method, and rotation is performed using Varimax with Kaiser Normalization. Number of observation = 14071.

**V. SUMMARY AND CONCLUDING REMARKS**

Through consistence empirical examinations, the thesis has met its objectives in analyzing both formal and informal institutional risks as well as their interaction effects on the performance of firms in emerging market economies. The major finding of this thesis can be summarized according to each objective as follow.

First, the objective one of this paper is to examine the effects of formal institutional risks on firm performance in 39 emerging market economies. Major finding of this objective can be summarized as follow.

There is robust evidence that improvement of aggregate institutional quality from very lower level has negative influence on firm performance. Only countries with quality of aggregate formal institutions reach a certain level (moderate level) so that further improvement would positively influence firm performance.

Better quality of legal institutions (institutions protecting private property and enforce contract) exert a positive influence on firm performance.

The higher the corruption the lower the firm performance in emerging markets. Better quality of political institutions (stable government) improves firm performance.

The second objective of this thesis seeks to examine the differential effects of cultural components (informal institutions) on firm performance in a group of emerging markets. The results are summarized as follow with respect to four Hofstede cultural components.

There is no statistical evidence that power distance exert a significant effect on firm performance in emerging market. Results shows that, in the emerging markets under preview, uncertainty avoidance, individualism, and masculinity exert negative effects on firm performance. However, the results show that long term orientation exerts a positive influence on the performance of firm in these countries. When alternative measure of informal institutions (social capital) was used, the study find that it exerts a strong positive influence on firm performance, suggesting emerging countries possessing high degree of social capital (e.g. trust) would have their firm performance increase.

Final objective of these study aims at examining the interaction effects of formal and informal institutions on firm performance. The major results are summarized as follow.

There are negative interaction effects between formal institutions and power distance cultural value in emerging markets. This complementary (negative) effect on firm performance tends to be particularly the case for emerging markets endows with very weak quality of formal institutions.

The interaction between formal institutions and uncertainty avoidance cultural value is found to have a positive effect on firm performance. This result indicates that emerging economies with high degree of uncertainty and ambiguity would tend to devise strong formal institutions. These complementarities would benefit firm performance positively.

Individualistic cultural value and formal institutions have a positive interaction effect on firm performance. In weak formal institutional quality, individualistic value can boost firm performance in emerging markets.

Similarly, there is also a positive interaction effects between formal institutions and masculinity on the performance of firms in emerging market economies. In emerging markets with cultural value oriented towards masculinity (e.g. assertiveness in acquisition of materials) would tend to induce strong institutions that ensure fairness in competitions and regulate and enforce rules and contracts in the society. This would benefit firm performance.

In contrary, the interaction effect between long-term orientation and formal institutions on firm performance is found to be negative. However, this is particularly the case at very low quality of formal institutions. Thus, long-term orientation may not contribute positively to better firm performance in a very weak formal institutional environment.

Similarly the case, when correlated nature of Hofstede components of cultural index is accounted for, the finding reveal that the interaction between formal institutions and mix cultural values of power distance, uncertainty avoidance and long-term orientation, on the one hand, and the mix cultural values of individualistic and masculinity, on the other hand, exert negative effects on firm performance but only at very low quality of formal institutions. This suggests that negative effects of formal institutions, at the low quality level, on firm performance are negatively complemented by these two unique components of the mixed cultural values.

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