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The effect of corruption distance and market orientation on the ownership choice of MNEs: Evidence from China

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A R T I C L E I N F O

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A B S T R A C T

Motivated by previous studies on the effect of corruption on entry strategies of Multinational Enterprises (MNEs), this research examines how corruption distance influences the choice between wholly owned subsidiary (WOS) and joint venture (JV) for MNEs operating in China. We found that MNEs from countries which are less corrupt than China prefer WOS over JV; the higher corruption distance it is between these countries and China, the higher probability their MNEs choose WOS over JV. In contrast, MNEs from equally and more corrupt countries do not prefer WOS over JV; nor the corruption distance affects their entry mode decision. Market orientation has a universal and powerful effect on the entry mode choice regardless which group of countries MNEs are from. It also weakens the tendency for MNEs from less corrupt countries to choose WOS over JV.

1. Introduction

The appropriate ownership of productive enterprise is a central issue in economic theory and a practical question for multinational enterprises (MNEs) establishing new foreign affiliates. With an unprecedented acceleration of worldwide foreign direct investment (FDI), the question has become the object of considerable study (Johnson and Paul, 1975; Anderson and Gatignon, 1986; Dunning, 1995, etc.). Among various entry mode choices, the wholly owned subsidiary (WOS) and the joint venture (JV) are the most important and complex investment forms compared to contract-based entry modes (Zhao et al., 2004). The choice between WOS and JV has been subject to extensive empirical investigations (see a summary by Morschett et al., 2010). Factors such as transaction cost related characteristics, international experience of the MNE, and cultural distance between the investing country and the host country have been found to have an impact on the choice. In this paper we introduce another important issue: the impact of corruption distance on the choice between WOS and JV.

Corruption, roughly defined as the abuse of public office for private gain, has generated an immense literature (Lambert-Mogiliansky et al., 2007). It is found to inhibit economic growth (Mauro, 1995), reduce the legitimacy of government (Anderson and Tverdova, 2003), and affect political and societal stability (Abed and Gupta, 2002). Although both developed and developing countries have various degrees of corruption, the problem of corruption is generally more prevalent in developing countries for a variety of political, societal and cultural reasons (Monnte and Papagni, 2007). In many developing nations, business ventures require a large number of official approvals, usually in the form of licences or permits, to operate. This provides government officials with the opportunity to reap private benefits at the cost of institutional and social efficiency. Foreign direct investment (FDI) into developing countries is a pertinent case where entry and operations are commonly subject to extensive official scrutiny. Although most developing country governments see attracting FDI as an important policy priority, inefficient bureaucratic procedures and corrupt government officials remain sufficiently widespread to discourage international ventures.

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Motivated by previous studies, we attempt to explore the effect of *corruption distance* on the ownership choice of MNEs operating in China. Our study departs from the existing literature in two principal respects. First, we propose that the *direction* of corruption distance matters. That is, relative to a given host country, MNEs from more corrupt and less corrupt countries may react differently to corruption in the host environment. Second, we study whether *corruption distance* between host and home country of MNE increases the preference of WOS over JV. In addition, we investigate whether MNEs establishing local market oriented affiliates and those establishing export oriented affiliates react to corruption distance differently. Current literature on the relationship between corruption and ownership choice has not considered this issue. But recent FDI studies have found that local market oriented FDI (also called horizontal FDI) and export-oriented FDI (also called vertical FDI) tend to be motivated by very different factors (e.g. Markusen and Maskus, 2002). Therefore, horizontal FDI and vertical FDI may have different responses to the host country institutional attributes such as the relative level of corruption in the host environment. Last but not least, we assess whether corruption distance and market orientation interact with each other in the process of entry mode decision.

China has become one of the top FDI recipient countries in the world; yet surprisingly limited research has been conducted to understand whether and how corruption in China affects entry strategies of MNEs. The rapid economic development that China has achieved so far by no means suggests that corruption is diminishing in this country. Instead, some scholars are concerned that corruption in China is becoming systemic (Root, 1996; Cheung, 1996). While there might be a host range of issues which are affected by corruption, we attempt to provide one of the first empirical investigations on the impact of corruption distance on the choice of entry mode of MNEs in China. This is a question of both empirical and practical significance to researchers, policy makers and MNEs in China. FDI regulations in China have long geared towards macroeconomic goal of promoting technology transfer and market competition. Therefore, policy makers may like to know how the relative corruption level in China affects the ownership structure of FDI projects because the structure affects the incentives of the foreign investors to apply their resources to the project, the degree of technology transfer, and the distribution of gains from FDI. For MNEs, ownership structure has a fundamental effect on how they allocate and control resources, coordinate with other parts of the corporation, and the prosperity of their operation in the host country.

The remainder of the paper is organized as follows. We review the literature on corruption and its impact on the global expansion of MNEs in Section 2. This in turn motivates the key hypotheses of the paper. We then introduce our empirical strategy in Section 3. Empirical results are reported in Section 4. Finally, we discuss and conclude our paper in Section 5.

2. Literature review

2.1. Literature on corruption and FDI

The effect of corruption on FDI has long been studied. There are different theoretical arguments suggesting a positive or negative effect of corruption on FDI. Habib and Zurawicki (2002) suggest that while foreign investors may shun corruption because they believe it is morally wrong (that is, on ethical grounds), they also may try to avoid corruption because it makes local operations risky, difficult to manage, and costly (that is, on economic grounds). Aizenman and Spiegel (2006) instead find that multinationals avoid corruption because of stringent home country laws. For instance, the Foreign Corrupt Practices Act of 1977, which forbids bribery by American multinationals, put US firms at a competitive disadvantage by seeking to prohibit their involvement in corrupt practices abroad. There are also posited both 'grabbing hand' and 'helping hand' effects, where it is acknowledged that bribery is costly for firms (Murphy et al., 1991; Boycko et al., 1995) but it may also 'grease the wheels' of commerce, especially in the presence of pre-existing government failures (Kaufmann and Wei, 1999). It then becomes an empirical question which effect is dominant.

The empirical evidence on corruption suggests a prevailing negative impact on FDI (Habib and Zurawicki, 2002; Aizenman and Spiegel, 2006). While such evidence is not surprising, Egger and Winner (2006) revealed a more complex relationship between corruption and FDI. They found that although corruption is negatively correlated with FDI, the effect is neither uniform across countries nor uniform over time. Corruption, in their panel data analysis, was found to be important for intra-OECD FDI, but not for extra-OECD FDI. They speculated that this is because most FDI in OECD countries is *horizontal*. For non-OECD, developing countries where most FDI is vertical, 'classical' locational advantages such as low wages and production costs were found to overwhelm the impact of corruption. They found in addition that the negative impact of corruption has declined over time. In a similar vein, Hakkala et al. (2005) directly differentiated horizontal and vertical Swedish FDI in their investigation and found that although corruption reduces the probability that a Swedish firm will invest in a country in general, once a decision is made to enter, corruption reduces horizontal FDI but has no significant impact on vertical FDI. This demonstrates the different reactions of horizontal and vertical FDI to the corruption in the host country and suggests the insufficiency of treating FDI as a homogenous phenomenon.

The relationship between corruption and ownership choice has received less attention in the literature. One of the earliest attempts is Smarzynska and Wei (2002). In their cross-sectional analysis of FDI in Eastern Bloc countries, high corruption of the host country leads to a preference of JV over WOS (see Table 1 for its methodological details). They interpreted that the choice of a lower level of ownership helps to reduce the commitment and associated risk in the invested projects and is a sensible reaction the Eastern Bloc countries which were quite unstable, risky and in transition environment in 1995. Their specific empirical context makes it tentative whether the result can be replicated in other countries. In contrast, Asiedu and Esfahani (2001) did not detect any significant impact of corruption on the choice between WOS and JV for US MNEs. But their exclusive data of overseas affiliates