Research Insights Series

Outward foreign direct investment from emerging economies: escaping home country regulative voids

Dr. Carmen Stoian, Lecturer in International Business at Kent Business School, University of Kent, features a joint paper* with WU-professor Alexander Mohr published in October 2016 in the *International Business Review*.

Abstract

Firms from emerging economies such as China, India, Brazil or Russia have increasingly invested abroad. These emerging economies are often characterised by regulative voids, i.e. missing, volatile or inadequate rules and regulations that are poorly enforced or monitored. Such rules and regulations comprise, inter alia, legislation regarding monopolies and state aid, regulations regarding bribery, corruption and the independence of the judiciary, as well as property rights legislation, including intellectual property rights legislation.

A recent paper of WU professor Alexander Mohr and a former colleague from Kent Business School, Carmen Stoian, argues that operating in regulative voids poses significant constrains on firms' resources, leading to competitive disadvantages; hence, companies invest internationally to escape from these pressures in their home country. However, to engage in international investment successfully, firms arguably still need to possess certain competitive advantages. In particular, competitive advantages derived from spill overs from inward foreign direct investment facilities escapist OFDI.

Non-technical Summary

Mohr and Stoian investigate the impact of home country regulative voids on outward foreign direct investment (OFDI) from 29 emerging economies over a 17-year period (1995-2011), using country level data. In particular, they focus on: a) the impact of three facets of regulative voids, i.e. home country high protectionism, high corruption and high bribery on the firms' decision to escape home country regulative voids through OFDI; b) whether the firms' competitive advantages derived from spill overs from inward foreign direct investment enhance the relationship between each facet of regulative voids and escapist OFDI.

The authors find that the more protectionism impairs economic activity, the more firms escape by investing abroad. This is because home country protectionism limits their growth potential in their home market due to over-regulated markets; it increases firms' costs and uncertainty through the presence of unfair competition; it limits the availability of production factors and/ or increases their costs; it creates uncertainty for firms in the presence of increased government intervention in their activities.

They also find that the more corruption exists in the home country, the more firms escape through OFDI. This is because corruption distorts competition, leading to inefficient allocation of resources, increased firms' costs and uncertainty; it creates bottlenecks, and increases the costs of doing business, in human, time and financial terms; corruption is usually associated with weak or absent property rights legislation and poor enforcement, leading to uncertainty and additional costs that limit domestic growth; countries with high corruption have a poor provision of infrastructure, thus increasing firms' costs and limiting their competitiveness; finally, countries with high corruption often experience lower levels of domestic economic growth, further driving escapist OFDI in the absence of opportunities for domestic growth.

However, the presence of high bureaucracy in the home country that hinders economic activity does not appear to influence OFDI. Instead, firms may use their ability to operate in bureaucratic environments to expand further domestically.

More importantly, the authors find that the three types of escapist OFDI investigated are enhanced by firms' competitive advantages derived from spillovers from inward foreign direct investment. Domestic firms' managers with international experience in foreign companies are able to identify easier opportunities to expand abroad, thus escaping home country protectionism, corruption and bribery. Access to the foreign investors' networks enhances escapist OFDI, as firms can acquire resources that are not available or are too expensive in the home country as a result of high protectionism; they can also engage in round-trip investment, thus escaping the pressures put on their resources by high bureaucracy in their home country; firms have more resources available to invest internationally, as integration into foreign investors' networks increases efficiency through economies of scale or adherence to enhanced standards of quality and costs. Labour mobility between the subsidiaries of foreign investors and domestic firms leads to enhanced competitive advantages through organisational learning, with higher skills being transferred to local firms by employees and managers with work experience in multinationals; these skills lead to higher resources available for expansion through OFDI. Depending on the ability of domestic firms to learn from foreign investors, domestic firms may also increase their efficiency and innovation, thus increasing the resources available for foreign investment. Finally, through learning from foreign investors and integration in their networks, domestic firms may use ethical standards of behaviour as a competitive advantage that diminishes their involvement in home country corruption and facilitates escapist OFDI.

Implications for managers

Based on our findings, Mohr and Stoian recommend:

1. Managers of domestic companies in emerging economies characterised by high protectionism, high corruption and high bureaucracy should be aware of the impact of such regulative voids

on their firms' strategy. These managers may opt to engage in escapist OFDI i.e. in developed economies to counteract the competitive disadvantages of operating in regulative voids.

2. Managers can also turn these competitive disadvantages into competitive advantages and exploit them by investing in countries with similar institutional contexts, i.e., other emerging economies. However, this raises concerns regarding the potential reinforcement of poor practices by multinationals from emerging economies that target highly protected, highly corrupt and highly bureaucratic economies, which possibly crowds out investment from multinationals from developed economies that are less able to address these institutional challenges deriving from regulative voids.
3. Finally, they recommend that managers of domestic companies in emerging economies learn from the subsidiaries of multinationals to enhance the competitive advantages of their companies and exploit them when engaging in escapist OFDI.

Implications for policy makers

The authors argue that OFDI needs to be encouraged responsibly by policy makers, given that OFDI has both positive and negative effects on a home country's economy. To encourage OFDI and benefit from its positive impact on the economy, they recommend:

1. Governments should tackle regulative voids and design policies that increase FDI, including fiscal and financial incentives that improve the investment climate, and facilitate spillovers to domestic companies. Policy makers should encourage collaboration along the supply chain, strategic alliances and labour mobility, and they should improve the legislation, the economic and technological development as well as the level of skills in the local economy; this can ensure that local companies learn from multinationals and, as a result, augment their competitive advantages and engage in OFDI.
2. Finally, governments of emerging economies should put in place reforms that reduce protectionism, corruption and bureaucracy. These reforms can encourage local firms to expand domestically rather than internationally, thus limiting the potential negative impact of OFDI on domestic economies. By investing at home, domestic firms also accelerate home country economic development. Furthermore, reducing regulative voids can attract foreign investors that further enhance the economic development of emerging economies.

*Original Paper

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