

5-2012

# Institution-Based Weaknesses Behin Emergin Multinationals

Mike W. Peng

*University of Texas at Dallas*

Ronaldo C. Parente

*Department of Management and International Business, Florida International University, ronaldo.parente@fiu.edu*

Follow this and additional works at: [https://digitalcommons.fiu.edu/business\\_fac](https://digitalcommons.fiu.edu/business_fac)



Part of the [Business Commons](#)

---

## Recommended Citation

Peng, Mike W. and Parente, Ronaldo C., "Institution-Based Weaknesses Behin Emergin Multinationals" (2012). *College of Business Faculty Publications*. 2.

[https://digitalcommons.fiu.edu/business\\_fac/2](https://digitalcommons.fiu.edu/business_fac/2)

This work is brought to you for free and open access by the College of Business at FIU Digital Commons. It has been accepted for inclusion in College of Business Faculty Publications by an authorized administrator of FIU Digital Commons. For more information, please contact [dcc@fiu.edu](mailto:dcc@fiu.edu).

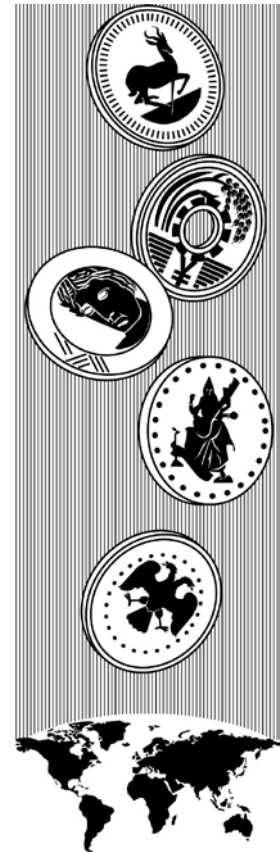
## INSTITUTION-BASED WEAKNESSES BEHIND EMERGING MULTINATIONALS

**Mike W. Peng** mikepeng@utdallas.edu

Professor at Jindal School of Management, University of Texas at Dallas – Richardson – TX, United States

**Ronaldo C. Parente** ronaldo.parente@fiu.edu

Professor at Department of Management and International Business, Florida International University – Miami – FL, United States and Professor at Escola Brasileira de Administração Pública e de Empresas, Fundação Getulio Vargas – Rio de Janeiro – RJ, Brazil



Undertaking foreign direct investment (FDI) is the defining feature of multinational enterprises (MNEs). While emerging economies as recipients of FDI are familiar with MNEs, these MNEs tend to be firms from the developed world. A new breed of home-grown MNEs has now arisen from the emerging economies, in particular the group known as BRIC (Brazil, Russia, India, and China). In this article, the term “emerging multinationals” is employed to refer to this new group of BRIC-based MNEs. The type of FDI made overseas by this group of emerging multinationals, is defined by a more accurate term, *outward* foreign direct investment (OFDI), that is now used to differentiate

it from the traditional FDI found in emerging economies, which is technically *inward* FDI (IFDI). Overall, the OFDI made by the emerging multinationals that form BRIC is responsible for almost half of all the OFDI from emerging economies. This new OFDI made by emerging multinationals has led to sensational headlines. How are these emerging multinationals different from their counterparts in developed economies? How can we make sense of them? How can experts in management provide a better understanding of the emerging multinationals?

Compared to the multinationals from developed economies, emerging multinationals are unique with regard to their relationship

with their national governments, their degree of political involvement, and the relative importance of their home markets. In addition, these emerging multinationals, in particular those from BRIC countries, may possess country-specific and firm-specific advantages in terms of natural resources, economies of scale, labor, and the cost of capital. The emergence of these new emerging multinationals is widely hailed as embodying the *strengths* of the home economies that give rise to them. This is true to a certain extent – it is impossible to generate surplus capital to fund overseas expansion if these firms are unable to achieve strong sales in their home economies and if their home economies have not grown in the

first place. The media has tended to treat this question in a sensational way, and it has attracted an increasing amount of documented academic research. This situation is consistent with the traditional MNE theory which addresses the strengths of the MNEs and their home economies.

However, what has not been covered by either the media or traditional theory is an opposing view of considerable importance that has been overlooked. This view suggests that a lot of the OFDI made by the emerging multinationals reflects the existence of a number of *institutional weaknesses* that can be found in their home economies in a macro context and possibly in the product, labor, and/or capital markets as well. These emerging multinationals are accustomed to operating in an environment that may lack an appropriate financial structure or mechanisms to protect investors in their home countries. This kind of national environment may also be characterized by less than optimal levels of transparency in their regulatory systems and business environments. We argue that a solid, balanced, and insightful understanding of this new phenomenon – OFDI made by emerging multinationals – cannot be attained without an equally determined attempt to probe the institution-based determinants that lie behind the emerging multinationals. This essay seeks to offset the almost one-sided coverage of the “strengths” side of this phenomenon by dealing with the “weaknesses”. Our aim is to leverage the recent emergence of OFDI to extend and enhance the institution-based view of international business strategy (PENG et al, 2008, 2009).

## **ANOMALIES IN THE PATTERN OF OFDI MADE BY EMERGING MULTINATIONALS**

Let us start with two leading questions:

- Which emerging economy of the BRIC group has generated the largest amount of OFDI stock?
- Which economy has received the largest amount of OFDI from multinationals in the following emerging countries: Brazil, Russia, India and China?

Based on the experience of our lectures and interviews with undergraduate, MBA, and executive education students around the world, when answering the first question, most people would cite China, followed by Brazil or India. Almost everybody in the room was shocked when we told them that of the BRIC countries, Russia has generated the largest amount of OFDI stock (KUZNETSOV, 2011). While the Western media is full of accounts of China’s OFDI, such as in Brazil (see *Brasil Econômico’s* interview with the first co-author of this article in 2010), Russia’s OFDI stock (2.1% of the world total) is much larger than China’s (1.5% of the world total) (UNCTAD, 2011). Yet, since 1991, no Western media outlet has bothered to report on any “Russia threat”. Instead, the media is full of articles about a perceived “China threat” in terms of economic competition. Russia’s economy (which has the 11th largest GDP) is much smaller (about four times) than China’s (with the 2nd largest GDP). If OFDI is a reflection of the streng-

ths of the home economy, how can firms from a much smaller and presumably weaker emerging economy generate so much more OFDI?

Moreover, the main recipient of Russia’s OFDI is tiny Cyprus. Brazil’s multinationals invest heavily in the British Virgin Islands (BVI), while India’s OFDI has flooded Mauritius. A full two-thirds of China’s OFDI has gone to Hong Kong, and the second largest recipient of China’s OFDI is the BVI. How can these relatively small economies, which are well-known as tax havens, absorb so much OFDI from BRIC? A close analysis of the available data shows that they do not. In fact, a high percentage of this OFDI is re-invested back to BRIC – this is known as capital round-tripping (FUNG et al, 2011). The principal foreign investors (of stock) in Brazil, Russia, India, and China are the BVI, Cyprus, Mauritius, and Hong Kong, respectively. In China, the BVI has the second largest FDI stock. In other words, the “real” OFDI that is used to acquire local outfits, build factories, and compete with local rivals is much smaller than the total OFDI dollar figures suggest. Why should managers and firms in BRIC undergo such an arduous process of capital round-tripping? We argue that the institutional weaknesses in the home economies are outweighed by the potential benefits associated with this kind of capital round-tripping.

## **INSTITUTION-BASED WEAKNESSES**

If it is taken into account that a considerable amount of the OFDI from BRIC is fueled by institution-based *weaknesses* in these emerging eco-

nomies, it follows that their domestic institutions for protecting private property and facilitating investment must be weak. For instance, in Brazil, bureaucratic regulations and heavy taxation on domestic earnings have created incentives for firms to invest overseas. As of 2008, two-thirds of Brazil's OFDI stock went to tax havens such as the BVI and Cayman Islands. Another related question is: Which economy in the Latin America and the Caribbean region has generated the largest OFDI stock? Almost everybody in our audience assumed it was Brazil, but it is not. It is the BVI – year in and year out. In 2010 (the most recent year for which data from the *World Investment Report 2011* are available), the BVI generated about twice the amount of OFDI flow as Brazil (\$21 billion versus \$11 billion). In the year before (2009), the BVI generated \$28 billion OFDI flow, while Brazil actually suffered from a large *negative* OFDI flow of \$10 billion (that is: Brazil received more IFDI than its OFDI abroad and the difference was \$10 billion). What happened in 2009 was very significant: Brazil's negative OFDI flow and the BVI's strong OFDI flow were due to intra-company loans from Brazilian MNEs' (primarily BVI-based) affiliates and subsidiaries to their parent companies at home, in an effort to combat the global recession that had a negative impact on Brazil.

As well as being concerned about the factors outlined above, in Russia, India, and China, managers and firms are concerned about political instability, which may result in the expropriation of their assets. Given the political uncertainty in Russia, this fear is likely to remain a strong economic factor. This at least partially explains the much higher

proportion of Russia's OFDI relative to GDP, noted earlier. In India, the License Raj was intimidating. The founders of Mittal Steel (now part of ArcelorMittal) were born in India, but draconian Indian regulations drove them abroad where they registered their firm in the Netherlands via OFDI. Then they invested money back to India and other countries. Likewise, Chinese regulations are friendlier to foreign investors than to domestic firms, especially domestic private firms. The Chinese government's rationale is to offer preferential treatment to lure foreign firms, and it has largely succeeded in this regard. However, the drawback of this policy is that it has driven many Chinese firms to invest overseas. Overall, in response to the hostile climate created by institutions in their home country, a large number of managers and firms in Russia, India, and China have made a rational decision to turn their operations at home into "subsidiaries" of foreign firms which are registered in places like Cyprus, Mauritius, and Hong Kong (and the BVI). In other words, when one probes more deeply into the institution-based reasoning behind decisions regarding OFDI from emerging economies, a lot of weaknesses in these economies are revealed.

## AN INSTITUTION-BASED RESEARCH AGENDA

Academic specialists have argued that institutional frameworks are made up of formal and informal constraints that interact with organizations. These institutional frameworks help firms by reducing uncertainty. Traditional research

into MNEs, which is almost exclusively based on the experience of MNEs from developed economies, has been conducted through a "strengths" perspective. As noted earlier, this "strengths" perspective can explain some of the OFDI made by emerging multinationals. However, it is clear that traditional theory cannot fully explain, nor help us predict, the strategy, behavior, and performance of emerging multinationals. Employing, broadening, and deepening our understanding of the "weaknesses" perspective is essential to supplement the "strengths" perspective.

We argue that what in theoretical terms can significantly help advance the "weaknesses" perspective is an institution-based view, which lays stress on the dynamic interaction between institutions and organizations, and takes full account of strategic choices as being the logical outcome of these interactions (PENG et al, 2008, 2009). The rationale is that strategic choices, such as undertaking OFDI, is not merely driven by industrial conditions and firm-specific resources, but are also a reflection of the formal and informal constraints of a particular institutional framework that managers confront. While the proposition that "institutions matter" is hardly novel or controversial, we have yet to unlock the institutional "black box" that lies behind the rise of OFDI from emerging multinationals. Existing theories about MNE either ignore capital round-tripping or experience difficulty in explaining it. A thorough search of material in the leading journal in the field, *Journal of International Business Studies (JIBS)*, since it was founded in 1970, discovered that when we used key phrases such as "round

tripping,” “institutional arbitrage,” and “regulatory arbitrage” in articles titles or abstracts, there was only a single article by Fung et al. (2011). While this article is a useful start, clearly more research needs to be conducted on these crucially important but surprisingly underexplored topics.

From an institution-based standpoint, MNEs that undertake capital round-tripping tend to engage in institutional or regulatory arbitrage (FUNG et al, 2011). If we endeavor to leverage the OFDI from emerging multinationals to build new theories and enhance our understanding of this new phenomenon in global competition, further institution-based research on the institutional weaknesses inherent in emerging economies that drive OFDI is required.

This institution-based research agenda is not only of significance for MNEs from emerging economies, but also potentially important for MNEs from developed economies as well. The following is a case in point: tax havens became tax havens *before* the more recent emergence of multinationals from BRIC. While Brazilian and Chinese MNEs are attracted to the BVI (their first and second OFDI destination, respectively), so do many US MNEs. The loopholes in US tax laws have led to many special-purpose entities in the BVI set up by American multinationals. As the Obama administration has become more desperate in its attempts to extract taxes from US-based firms, the BVI can expect more FDI dollars from the United States. We can speculate that for the same reason that the small islands of the BVI, with a total population of 30,000, cannot absorb that much FDI from BRIC, it also

cannot absorb a large amount from the United States. In view of this, it can be assumed that much of the US OFDI to places such as the BVI will be going back home too. Hence, when examining the institution-based logic behind OFDI, there are signs of convergence of both the emerging and developed economies.

Given this convergence, what, then, are the differences between MNEs from the emerging and developed economies that make use of tax havens? The answer depends on the question of degree. Despite the existence of numerous US special-purpose entities in the BVI and the Cayman Islands, presumably for tax haven purposes, these countries do not appear on either the list of the top five recipient countries of the US OFDI or on the list of the top five countries making IFDI in the United States. These countries are routinely among the top five for both OFDI from Brazil and China and IFDI in Brazil and China.

In view of this, it is reasonable to ask whether this OFDI to tax havens for capital round-tripping purposes will decrease as emerging economies develop more business-friendly institutions. This may be the case, but it is evident that as the US loses its competitiveness in offering business-friendly institutions (in other words, if the tax burdens become too high for US firms), the BVI and the Cayman Islands may one day appear on the list of the top five recipient countries of US OFDI or on the list of the top five countries making IFDI in the United States. In short, the institution-based weaknesses of the US economy may also drive some of its firms to undertake similar OFDI.

## POLICY AND MANAGERIAL IMPLICATIONS

For policymakers in emerging economies, the implications of what has been discussed above are two-fold. First, they must strengthen their positive role in support of OFDI. For example, the Brazilian Development Bank – Banco Nacional de Desenvolvimento Econômico e Social, BNDES – has acted as an intermediary for a lot of OFDI that has been undertaken by emerging multinationals from Brazil. Second, policymakers in emerging economies must take steps to reduce the negative aspects of their role. Unequal treatment between domestic and foreign firms has driven some Chinese firms abroad. Thus, if this unequal treatment (technically abolished as of 2008) can be rectified, it may reduce some capital round-tripping. In Russia, a greater respect for the law would remove a large number of uncertainties on the part of many Russian firms and managers, who might decide to invest in Russia instead of making the arduous capital round-trip. In India, reducing the discretion of the License Raj would go a long way to making badly needed investment available for industry at home.

Policymakers in host countries should embrace a pragmatic form of nationalism as opposed to being excessively alarmed. While Brazil's and India's OFDI does not lead to a lot of political resistance abroad, Russia's OFDI is an especially sensitive issue in the former Soviet bloc countries such as Hungary, Poland, and Latvia (itself part of the Soviet Union between 1941 and 1991). The return of the Rus-

sian “bear” is a constant national nightmare for some of these countries. China’s OFDI often provokes the fear in the West that China is “buying up the world”. Pragmatic nationalism involves considering both the pros and cons of FDI and approving FDI only when its benefits outweigh its costs. It should be remembered that the media “hoo-pla” tends to focus on the strengths of the economies that generate this kind of OFDI. However, as noted earlier, a lot of this OFDI is a reflection of the weaknesses of these economies, and much of this OFDI goes back home via capital round-tripping – this is something the media has often failed to detect or chosen to ignore. In short, the bear from Russia or the dragon from China are really not so intimidating, and they have a tendency to go back home(!).

Managers from emerging multinationals should learn how to master the “rules of the game” both at home and abroad. While being “stuck at home” may be unpleasant, investing (and in many cases operating) in host countries may not be a “walk in the park” either. Even in the case of managers whose ultimate aim is to invest back home after making the arduous capital round-trip, one potential benefit that they can leverage is that these endeavors can indeed broaden their outlook and globalize their mindset. Why not take advantage of these opportunities to globalize their firm? As the founders of Mittal Steel found out, after they left India, the world is their “oyster.” Once it was thoroughly globalized, Mittal Steel ended up acquiring Arcelor and forming ArcelorMittal (the largest steel-maker in the world). This is an achievement that would have

never materialized had Mittal Steel only focused on engaging in capital round-tripping to go back to India.

“Act local, think global” is something we always teach students in our international business classes. While this slogan was coined to refer to the location-by-location competition of traditional MNEs, we can stretch it to describe the OFDI of emerging multinationals. Essentially, “acting local”, has meant that a lot of them have struggled to deal with institutional difficulties in their home country. While “thinking global”, they have endeavored to use capital round-tripping to overcome these national problems. However, as the example of Mittal Steel makes clear, once these emerging multinationals “think global”, they do not have to “act local” (while only focusing on their home country). In other words, once they start to “think global,” they can also “act global” by globalizing their managerial mindset and turning their firms into true global competitors instead.

#### ACKNOWLEDGEMENT

The ideas for this paper were first presented at the Strategic Management Society Special Conference on Latin America, March 2011, in Rio de Janeiro, Brazil. This research was supported by the Jindal Chair and the Provost’s Distinguished Professorship at UT Dallas. We would also like to thank Flavio Vasconcelos, Dean of Escola Brasileira de Administração Pública e Empresas, Fundação Getulio Vargas (FGV-EBAPE), for his support for this research while one of the authors was visiting FGV-EBAPE.

## REFERENCES

- BRASIL ECONOMICO. M. Peng: Prós e contras do investimento Chinês no Brasil. p. 8-9, June 30, 2010.
- FUNG, H.-G; YAU, J; ZHANG, G. Reported trade figure discrepancy, regulatory arbitrage, and round-tripping: Evidence from the China-Hong Kong trade data. *Journal of International Business Studies*, v. 42, n. 1, p. 152-176, 2011.
- KUZNETSOV, A. Outward FDI from Russia and its policy context, update 2011. *Columbia FDI Profiles*, August 2, 2011.
- PENG, M. W, SUN, S. L, PINKHAM, B; CHEN, H. The institution-based view as a third leg for a strategy tripod. *Academy of Management Perspectives*, v. 23, n. 3, p. 63-81, 2009.
- PENG, M. W, WANG, D; JIANG, Y. An institution-based view of international business strategy: A focus on emerging economies. *Journal of International Business Studies*, v. 39, n. 5, p. 920-936, 2008.
- UNCTAD. *World Investment Report 2011*. New York and Geneva: UNCTAD, 2011.