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Governance and the Choice of Entry Mode by FDI Firms Entering China

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Abstract

In the past 20 years, China's economy made a dramatic change. This was likely due to its improved institutional environment. In this study, we use 6 governance indicators, compiled by World Bank, to measure the change in China's institutional environment and to provide some empirical evidence of the linkage between the quality of governance and a firm's choice on entry mode. We determined that improved political stability, regulatory quality and rule of law would induce foreign firms entering China to be more willing to utilize a high-commitment entry mode, and thus, would result in more stable capital investment from foreign organizations.

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1. Introduction

Prior to 1990, the amount of FDI (Foreign Direst Investment) in China was tiny relative to the size of economy, as the average FDI of its GDP (Gross Domestic Production) was lower than the world average. But, as China embarked upon a series of reforms during the 1990s, its FDI flows surged. Between 1990 and 2003, China's inflows averaged 4.3% of its GDP, or double the world's average of 2.1% (Fan et al., 2007). After joining the WTO (World Trade Organization), from 2002 through 2006, China's economy showed an even more impressive reform in the institutional environment: over 2000 rules and regulations associated with economic development were amended or created, and over 800 outdated rules or regulations were deleted[1].

Previous studies have found that quality of governance is positively correlated with FDI (Gani, 2007; Globerman and Shapiro, 2002; Globerman et al., 2004; Sin and Leung, 2001; Harms, 2002). The reform of the Chinese economy improved the quality of governance in China and led to a rapid increase in FDI flows (Fan et al., 2007). In 2008, China and Hong Kong accounted for over half of the FDI inflows in Asia, or 150 billion US dollars, and was reported to be the fourth largest FDI recipient in the world (UNCTAD's World Investment Report 2008).

The FDI literature has primarily focused on how governance affects FDI flows, however, few studies explore the linkage between the entry strategy of firms and the quality of governance. Studies associated with international business have paid a great deal of attention into investigating the strategic decisions by firms on entry mode (Canabal and White, 2008). Surprisingly, there has been little to say of the relationship between the governance environment and FDI entry decision (Filatotchev et al., 2007). As a result of the rapid change in the quality of governance and the large inflows of FDI into China, we are curious about the FDI strategies of firms entering China, with a particular focus on the linkage between the quality of governance and the choice of entry mode.

2. Literature and the Analytical Framework

There have been a series of studies investigating the relationship between FDI flows and governance. Gani (2007) analyzed a sample of countries from Asia and Latin America to illustrate that a good quality of governance leads to high inflows of FDI. Globerman and Shapiro (2002) and Globerman et al. (2004) pointed out that good governance promotes the FDI in developing and emerging transition European countries. Fang et al. (2007) indicated that the FDI in China elevated because of improved institutional environment. Other research has focused on the relationship between the political environment and the FDI. Sin and Leung

[1] Newsletter published by Chung-Hua Institution for Economic Research, no. 0818.

(2001) indicated that liberal policy leads to more FDI inflows, while Harms (2002) revealed that politic risk has great impacts on the FDI flows in developing countries. However, they did not mention the firm's choice of entry mode. The linkage between the governance and entry mode of FDI firms did not be noted until Slangen and Tulder (2009). They found that joint ventures were more likely to be chosen by companies when the governance quality was low. Even though the issue of entry mode has been emphasized by literature associated with international business[2], studies focused on the linkage between the governance and entry mode of FDI firms remained scarce.

The model for the empirical analysis is represented by the following logistic model:

$$Y = ßK+aL+u$$

Where, Y denotes the level of equity stake taken by the parent company in its host country affiliate (0=when the ownership was less than 50% in minority equity; 1=when the ownership was over 50% in majority equity[3]), K denotes a vector of the FDI control variables (R&D intensity, parent company size, Leverage, the return of asset (ROA) of parent company and a dummy variable dividing sample into two groups, before and after entering WTO), L denotes indicators of governance (the rule of law, control of corruption, regulatory quality, government effectiveness, political stability, voice and accountability), u represents all unobservable variables.

Good governance leads to low environmental uncertainty and risk (La Porta et al., 1999; Classen et al., 2001). Studies have pointed out that the greater the uncertainty, the lower the quantity stake initially taken by the parent company (Kale and Puranam, 2004; Dixit, 1989, Abel et al., 1996; Lee, 2004). Moreover, the governance indicators are also a good proxy to measure environment uncertainty (Thomas,2006; Slangen and Tulder, 2009). We expect that the parent company's ownership in its overseas affiliate is positively associated with governance indicators.

In investigating the impact of governance on ownership strategy, we need to control for other variables, drawing upon the effect established in the literature (Dunning, 1993; Hennart and Park, 1994). Large companies, measured by the natural log of the authorized capital of the parent company, typically possess greater financial and managerial capability, and hence, have less need for cooperation with others. Technology-intensive firms, proxied by R&D expenditures as a percentage of sales, will favor a high-commitment entry mode, as they will want to internalize their proprietary technology and managerial know-how and minimize the potential for opportunistic behavior by their partner. ROA represents the firms' performance.

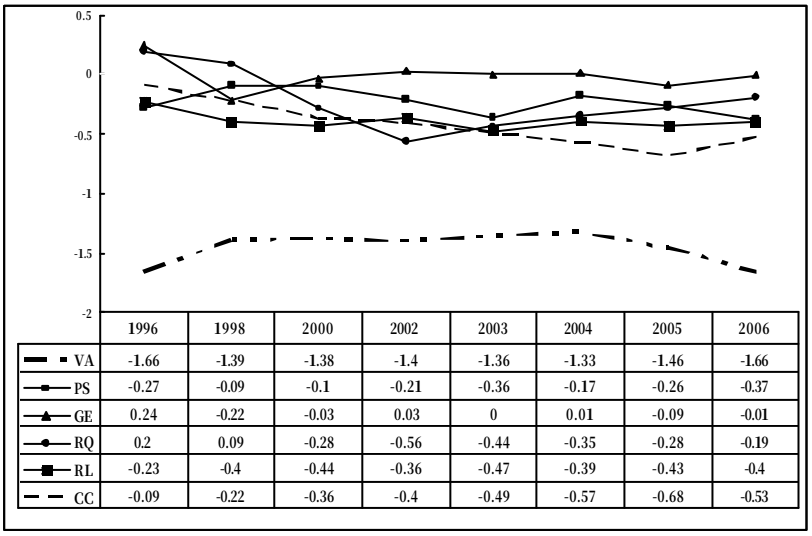
[2] Canabal and White (2008) provided a detailed survey for this series of literature.
[3] Yan and Gray (1994), Mjoen and Tallman (1997) also followed this setting.

Firms with good performance may tend to have high-commitments, because of their confidence from their past success (Pan and Chi, 1999; Zhang et al., 2007). Leverage is a critical factor affecting firm's operational risk and proxied by total debts to total assets (Li and Meyer, 2008). Moreover, China relaxed its restriction on foreign share ownership after entering WTO in 2001. This may cause firms to frequently choose majority equity as their entry mode after 2001. Therefore, we include a dummy variable to control the impact from the time-trend effect of entering WTO, which assign 1 to the samples after 2001 and 0 to those before 2001.

3. Data and Estimation

The indicators of governance include: the rules of law (RL), control of corruption (CC), regulatory quality (RQ), government effectiveness (GE), political stability (PS) and voice and accountability (VA). The source of data for governance indicators is from Kaufmann et al. (2007), which assigned most of the 203 countries in their analysis a score on each dimension for the year 1996, 1998, 2000, 2002, 2003, 2004, 2005 and 2006 that varied between -2.5 and 2.5. The higher the score of each indicator is, the better the governance quality is. Table 1 shows the time series of the six governance indicators. VA is the worst aspect in the past 10 years, with an average score less than -1. RQ shows the largest variation, varying from -0.56 to 0.2. GE is the one with the best performance after 2000, with a score varying around 0. Surprisingly, the indicators do not show a trend toward steady increasing after China entering WTO, even some indicators, like VA, PS, RQ and RL, exhibit a downward trend from 2004 to 2006, suggesting that entering WTO does not lead to a subsequent improvement of governance quality in China. We use the indicators to measure the governance infrastructure in China. For the uneven years of 1996-2003 period, we use the dimension scores of the preceding year in our sample.

Table 1. The time series of the governance indicators from 1996~2006



	1996	1998	2000	2002	2003	2004	2005	2006
VA	-1.66	-1.39	-1.38	-1.4	-1.36	-1.33	-1.46	-1.66
PS	-0.27	-0.09	-0.1	-0.21	-0.36	-0.17	-0.26	-0.37
GE	0.24	-0.22	-0.03	0.03	0	0.01	-0.09	-0.01
RQ	0.2	0.09	-0.28	-0.56	-0.44	-0.35	-0.28	-0.19
RL	-0.23	-0.4	-0.44	-0.36	-0.47	-0.39	-0.43	-0.4
CC	-0.09	-0.22	-0.36	-0.4	-0.49	-0.57	-0.68	-0.53

We use 1600 Taiwanese electronics firms into China during the period January 1996 to December 2006 to evaluate the equity stake taken by the Taiwan parent company in its China affiliate. The choice of China as the host economy was made on the grounds that it had a dramatic change in the governance structure over the past twenty decades, and has been the host to vast amount of FDI flows. China also has a large spatial economy with a diverse pattern of FDI (Cheng and Kwan, 2002).

Taiwan was selected as the home country for two reasons. First, Taiwan is a relatively well-developed newly industrial Asian economy, with numbers of companies listed on the domestic stock exchange. Many of these firms are engaged in the FDI, and provide reliable and accurate data about shareholdings[4]. Second, people from China and Taiwan share common cultures and heritages, thus, we can ignore the influence from the difference of cultures (Kogut and Singh, 1988).

To better understand how sample is distributed over time, we report in Table 2 the numbers of firms entering with majority or minority ownership for each year. Number of firms entering China increased rapidly from 4 in 1996 to 276 in 2003. After 2003, the entering number tended toward steady and showed a little decline from 270 in 2004 to 182 in 2006. However, the proportions of firms entering with majority equity stayed around 80% throughout, without being affected by the dramatic variation of total entry amount.

Table 2. Yearly Distribution of Entry mode Chosen by Firms Entering China

			Entry Mode		
			Minority Equity (y=0)	Majority Equity (y=1)	Total
year	1996	Count	1	3	4
		% within year	25.00%	75.00%	100.00%
	1997	Count	10	44	54
		% within year	18.50%	81.50%	100.00%
	1998	Count	13	47	60
		% within year	21.70%	78.30%	100.00%
	1999	Count	6	45	51
		% within year	11.80%	88.20%	100.00%
	2000	Count	20	90	110
		% within year	18.20%	81.80%	100.00%
	2001	Count	15	128	143
		% within year	10.50%	89.50%	100.00%
	2002	Count	54	222	276
		% within year	19.60%	80.40%	100.00%
	2003	Count	79	191	270
		% within year	29.30%	70.70%	100.00%
	2004	Count	28	211	239
		% within year	11.70%	88.30%	100.00%
	2005	Count	42	169	211
		% within year	19.90%	80.10%	100.00%
	2006	Count	35	147	182
		% within year	19.20%	80.80%	100.00%
Total		Count	303	1297	1600
		% within year	18.90%	81.10%	100.00%

[4] The data were obtained from the Security and Futures Commission in Taiwan. All companies listed on the Taiwan Stock Exchange are required to submit annual reports to the Commission. This makes the data reliable.

Table 3 provides the summary statistics. Firms entering China with majority equity on average account for 81.1% of total samples. The average score of each governance indicator is -0.231 about the political stability, -0.408 about the rules of law, -0.462 about the control of corruption, -1.426 about the voice and accountability, -0.018 about the government effectiveness and -0.312 about the regulatory quality. In Regard to the control variables, on average, the sample firm has a ROA of 11.66%, capitalization of 14.569 thousand dollars after taking natural log, a R&D expenditure ratio of 3.342% and a leverage ratio of 78.473%. The correlation table is also included in the Table 3. The correlations between the control variables and governance indicators are lower than 0.2, suggesting that multicollinearity is not a concern.

Table 3: Descriptive Statistics and Correlations

	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1 Entry mode	0.811	0.392	1.00										
2 PS	-0.231	0.100	0.11 ****	1.00									
3 RL	-0.408	0.050	0.05 **	0.16 ****	1.00								
4 CC	-0.462	0.142	0.01	0.41 ****	0.44 ****	1.00							
5 VA	-1.426	0.105	0.01	0.48 ****	-0.39 ****	-0.04	1.00						
6 GE	-0.018	0.081	-0.01	-0.30 ****	0.53 ****	0.16 ****	-0.22 ****	1.00					
7 RQ	-0.312	0.191	0.04	0.18 ****	0.27 ****	0.40 ****	-0.48 ****	-0.24 ****	1.00				
8 ROA	11.066	10.350	0.14 ****	0.02	0.04	0.09 ***	-0.04 *	0.03	0.05 *	1.00			
9 Size	14.569	1.460	-0.08 ***	-0.13 ****	-0.04	-0.07 ***	-0.12 ****	-0.02	0.02 **	-0.17 ****	1.00		
10 R&D	3.242	4.291	0.06 **	0.07 ***	0.00	-0.05 **	0.04 *	-0.03	-0.04	-0.11 ****	-0.13 ****	1.00	
11 Leverage	78.473	75.449	-0.06 ***	-0.05 **	0.00	-0.09 ***	-0.03	0.01	0.01	-0.26 ****	0.03 **	-0.14 ****	1.00

The Variables is defined as follows: PS, RL, CC, VA, GE and RQ are represented as political stability, rule of law, control of corruption, voice and accountability, Government Effectiveness, and Regulatory Quality. ****, ***, **, and * denote the significance level of 0.1%, 1%, 5%, and 10%, respectively. Entry mode is defined as 1 when firm entering with more than 50% ownership and 0 when entering with

4. Testing Results

Table 4 reports the regression results. Each of the six governance measures was tested separately, as shown in Columns 1-7, so as to avoid overlapping effects. Model 1 only contains the control variables. Their effects are largely in line with the prior literature. The effect of entering WTO has non-significant influence on the decision of entry mode, presumably because entering WTO does not imply a positive effect on the quality of governance.

Model 2 tests our hypothesis that lower political stability is more likely to be associated with minority equity ownership than with majority equity ownership. The test result is supportive as the coefficient of the governance indicator, PS, is significantly positive in Model 2, indicating that firms are more likely to enter China with a more stable political environment through choosing majority equity. Models 3 through 7 examine the effects of the different dimensions of China governance quality. Their regression coefficients indicate that RL and RQ have significant impacts on entry mode choice while the three other governance indicators, CC, GE and VA, had no significant impact. Interestingly, political stability has the

largest impact (ß=3.18), followed by rule of law (ß=2.557) and then regularity quality (ß=0.88), implying that China's stability of political environment is what entering firms care the most. Furthermore, the effect of entering WTO remains non-significant in all other models except one (Model 2).

To further distinguish the effect of entering WTO from the effect of change in governance quality, we replace the governance indicators in the form of continuous valuables with those in the form of 0-1 dummy variables. The dummy variable in a year assumes a value of 1 if the governance indicator's score in that year is higher than the indicator's sample mean as described in table 3 and 0 when lower than the sample mean. Using dummy variable exhibits clear information regarding the difference between the samples in the years with higher-than-average governance quality and those in the years with lower-than average governance quality. Table 5 summarizes the distribution of the governance indicators in the form of dummy variables. The last column titled subtotal gives the number of governance indicator with score 1 in each year. The value can be regarded as a composite measure of governance quality, with higher value implying higher governance quality. As shown, the governance quality after 2001 is not any better compared to that before 2001, indicating that entering WTO did not result in a subsequent improvement of China's governance environment. Table 6 shows the results of regressions with dummy governance variables. The result is consistent with table 4, that political stability, regulatory quality and rule of law have significant impacts and coefficients are sighted in line with our expectation, while WTO effect has no significant explanation on entry mode choice, meaning that the variation of entry mode choice (majority or minority equity) is more responsive to the variation of governance quality (high or low quality) than the time-trend effect of entering WTO. Although entering WTO requires China to relax the restriction on foreign equity ownership, it is not a significant reason that leads firms to choose high-commitment entry mode to enter China. The quality of governance infrastructure is what an entering firm is concerned with, especially the stability of political environment in China.

Table4: The Determinants of Entry Mode Chosen by Firms into China – Logit Model

	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7	
	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald
PS			3.18****	17.824										
RL					2.557*	3.31								
CC							-0.104	0.026						
VA									0.122	0.038				
GE											-0.514	0.401		
RQ													0.884*	3.656
ROA	0.036****	25.26	0.037****	27.08	0.035****	24.904	0.036****	25.257	0.036****	25.293	0.036****	25.498	0.036****	25.419
Size	-0.086*	3.676	-0.061	1.788	-0.085*	3.564	-0.086*	3.701	-0.085*	3.486	-0.086*	3.726	-0.091**	4.081
R&D intensity	0.05**	6.369	0.041**	4.544	0.048**	6.108	0.049**	6.342	0.049**	6.356	0.049**	6.309	0.049**	6.303
Leverage	0	0.29	0	0.183	0	0.355	0	0.303	0	0.275	0	0.281	-0.001	0.446
WTO(Dummy)	-0.003	0.001	0.197**	3.892	0.037	0.168	-0.016	0.018	-0.004	0.002	0.007	0.006	0.147	1.598
Intercept	2.246***	10.467	2.51****	12.786	3.261****	13.251	2.4**	5.233	2.4**	5.233	2.237***	10.379	2.511****	12.44
Log Likehood	1508.876		1490.852		1505.488		1508.869		1508.857		1508.498		1505.249	
Pseudo-R^2	0.0272		0.0381		0.0293		0.0272		0.0272		0.0274		0.0294	
Model $?^2$	44.114****		62.158****		47.521****		44.140****		44.152****		44.512****		47.761****	
Obsevations	1600		1600		1600		1600		1600		1600		1600	

The Variables is defined as follows: PS, RL, CC, VA, GE and RQ represent political stability, rule of law, control of corruption, voice and accountability, Government Effectiveness, and Regulatory Quality. ****, ***, **, and * denote the significance level of 0.1%, 1%, 5%, and 10%, respectively. Dependent variable is denoted as 1 when a firm entering China with more than 50% ownership and 0 when entering with lower than 50% ownership.

Table5: TheDistribution of Goveenance Indicator in the Form of a Dummy Variable from 1996 to 2006

year	DPS	DRL	DCC	DVA	DGE	DRQ	subtotal
1996	0	1	1	0	1	1	4
1997	0	1	1	0	1	1	4
1998	1	1	1	1	0	1	5
1999	1	1	1	1	0	1	5
2000	1	0	1	1	0	1	4
2001	1	0	1	1	0	1	4
2002	1	1	1	1	1	0	5
2003	0	0	0	1	1	0	2
2004	1	1	0	1	1	0	4
2005	0	0	0	0	0	1	1
2006	0	1	0	0	1	1	3

DPS, DRL, DCC, DVA, DGE and DRQ represent political stability, rule of law, control of corruption, voice and accountability, Government Effectiveness, and Regulatory Quality, respectively in the form of a 0-1 dummy variable, which assumes a value of 1 when the indicator's score is more than the indicators's sample average and 0 when lower than the sample average.

Table6: The Determinants of Entry Mode Chosen by Firms entering China –Dummy Governance Indicators

	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7	
	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald
DPS			0.455****	11.235										
DRL					0.256**	3.851								
DCC							0.198	1.554						
DVA									-0.016	0.012				
DGE											-0.276*	3.274		
DRQ													0.258*	3.047
ROA	0.036****	25.26	0.036****	25.465	0.035****	24.386	0.036****	25.485	0.036****	25.238	0.037****	26.327	0.036****	25.223
Size	-0.086*	3.676	-0.067	2.201	-0.087*	3.754	-0.081*	3.214	-0.087*	3.662	-0.085*	3.556	-0.093**	4.257
R&D intensity	0.05**	6.369	0.044**	5.199	0.048**	6.128	0.049**	6.206	0.05**	6.367	0.048**	5.925	0.048**	6.065
Leverage	0	0.29	0	0.208	-0.001	0.431	0	0.171	0	0.297	0	0.226	0	0.356
WTO(Dummy)	-0.003	0.001	0.069	0.584	0.01	0.013	0.067	0.41	-0.003	0.002	0.071	0.54	0.077	0.604
Intercept	2.246***	10.467	1.7**	5.687	2.138***	9.384	2.033***	8.116	2.269***	9.809	2.353****	11.34	2.18***	9.746
Log Likehood	1508.876		1497.587		1505.043		1507.315		1508.883		1505.554		1505.806	
Pseudo-R^2	0.0272		0.034		0.0295		0.0282		0.0272		0.0292		0.0291	
Model $?^2$	44.114****		55.423****		47.966****		45.694****		44.126****		47.455****		47.203****	
Obsevations	1600		1600		1600		1600		1600		1600			

The Variables is defined as follows: DPS, DRL, DCC, DVA, DGE and DRQ represente political stability, rule of law, control of corruption, voice and accountability, Government Effectiveness, and Regulatory Quality, respectively in the form of a 0-1 dummy variable, which assumes a value of 1 when the indicator's score is more than the indicators's sample average and 0 when lower than the sample average. ****, ***, **, and * denote the significance level of 0.1%, 1%, 5%, and 10%, respectively. Dependent variable is denoted as 1 when a firm entering China with more than 50% ownership and 0 when entering with lower than 50% ownership.

4. Conclusions

This study provides empirical evidence on the linkage between the quality of governance and the firms' choice on entry mode in China. We find that the stability of politics environment is what the firms entering China care the most and then the rule of law and the regulatory quality. As to the other dimensions of governance quality, control of corruption, government effectiveness and voice and accountability, have no significant impact on firms' entry mode choice when entering China. Past studies illustrated that the improved institutional environment in China is the major factor that enhances FDI inflows. In this paper, a greater understanding of improving the achievement in political stability, regulatory quality and rule of law in China induces foreign firms entering China to be more willing to use a high-commitment entry mode, and thus, attracts more stable and longer foreign funds.

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