

Institutional Environment, Institutional Distance and Chinese OFDI - A Literature Review

Xueqing Zhu

Shanghai University of International Business and Economics, Shanghai, 200000, China
zhuxq0211@163.com

Abstract: *This paper sorts out the relationship between absolute institutional factors and bilateral institutional distance and the location choice of Chinese OFDI, including the methods of measuring absolute institutional quality and institutional distance, and the impact of institutional quality or institutional distance on the location choice of Chinese OFDI. Currently, there is no unified standard for measuring institutional quality and calculating institutional distance, but scholars mainly use the World Governance Indicators (WGI) to measure institutional quality and bilateral institutional distance. Regarding institutional quality, there is no uniformity in the impact of the bilateral institutional environment on China's OFDI, and there are even opposing views. There are institutional risk aversion and institutional risk preferences regarding institutional quality, and institutional escape and institutional proximity theories regarding institutional distance. As research progresses, more and more scholars are also aware of the need for heterogeneity analysis of countries, regional industries, etc.*

Keywords: *institutional quality; institutional distance; Chinese OFDI*

1. Introduction

Since the implementation of the "going out" strategy in the reform and opening up, the pace of "going out" has continued to accelerate and has led to rapid growth in China's outward investment. The "going out" strategy has provided an important development opportunity for Chinese enterprises' Outward Foreign Direct Investment (OFDI). According to data released by the Department of Foreign Investment and Economic Cooperation of the Ministry of Commerce of China, from January to August 2022, China's outward sector-wide direct investment was RMB 621.87 billion, up 2.4% year-on-year. According to the World Investment Report 2020, as of the end of 2019, the global OFDI stock was USD 34.6 trillion, with the United States, the Netherlands, and China being the top three countries in terms of global OFDI stock size, with the United States and the Netherlands ranking first and second globally with a stock size of USD 772.71 billion and USD 2,565.29 billion respectively. China's outward FDI stock remained stable as a share of the world, and the 2019 China Outward FDI Statistical Bulletin showed that China's outward FDI stock was US\$219.88 billion by the end of 2019, accounting for 6.4% of the global share.

At present, the world is undergoing a major change unprecedented in a century, especially due to the impact of the global spread of the New Crown Pneumonia epidemic, the international political and economic landscape has accelerated its restructuring, and the world economy has fallen into recession, the traditional international cycle has weakened, unilateralism and protectionism have risen, reverse globalization has intensified, and global cross-border direct investment has continued to decline, which has profoundly affected the external environment for Chinese enterprises going abroad. In this turbulent external environment and the face of a century of great changes in the world's political and economic landscape, China has proposed a "double-circle" strategy of building a new development pattern in which "the major domestic cycle is the mainstay and the domestic and international cycles promote each other". The task is to cultivate new advantages for China to participate in international cooperation and competition under the new situation. However, China's OFDI location selection is characterized by a significant "blind pile-up", and mistakes in OFDI location selection by multinational enterprises due to the neglect of institutional differences have become an important factor hindering Chinese enterprises from "going global".

In the past, market factors were generally considered to be the dominant factor influencing the location choice of Chinese OFDI, i.e. Chinese OFDI was mainly motivated by resource-seeking or strategic-seeking motives. Scholars have found that OFDI is not only influenced by market factors such as the host country's market size, resource endowment, technology level, and inflation rate, but also by

non-market factors such as the host country's institutional environment and various institutional distances.

This is especially true as the scale of China's OFDI expands and the location distribution becomes more diversified. The location factors affecting OFDI in China are becoming increasingly complex, and it is too one-sided to consider the impact of market factors alone on OFDI, while the institutional environment is often seen as a potential cost influencing the choice of MNCs for OFDI. Institutional factors - including political, economic, and cultural dimensions - are becoming more prominent in influencing the location choice and flow of Chinese OFDI.

Existing research on the impact of institutional factors on OFDI location choice has focused on two aspects: the impact of absolute institutional quality on OFDI, and the impact of relative institutional distance between two countries on OFDI.

2. Institutional quality measures

2.1 Three common measures of institutional quality

Institutions can be divided into "formal institutions", which are composed of legal provisions and economic rules, and "informal institutions", which are composed of behavioral norms and codes of conduct. The following indicators are used to measure the quality of institutions, which are usually divided into political, economic, and cultural institutions.

(1) Political system quality

The quality of political systems is measured by the World Governance Indicators (WGI), which contains data on six dimensions, namely corruption control, government efficiency, political stability, regulatory quality, rule of law, and government accountability. This indicator is derived from the World Bank.

(2) Quality of the economic system

The quality of the economic system is measured by the Economic Freedom Index (EFI). The EFI consists of ten dimensions: trade policy, government fiscal burden, government intervention in the economy, monetary policy, capital flows, and foreign investment, financial sector, wages and prices, protection of property rights, government regulation, and information markets. Since 2007, the index has been rated on a percentage scale, with higher scores indicating a more liberal economy. This index is derived from the Heritage Foundation.

(3) Quality of cultural institutions

The quality of the cultural system is measured by the Hofstede Cultural Dimensions. These include the six cultural dimensions of rights, individualism/collectivism, masculinity/femininity, uncertainty avoidance, long/short-term orientation, and permissiveness and restraint. The indicators of cultural dimensions for each country were obtained from the Hofstede website.

2.2 Application of institutional quality measures

In studies of institutional environments, the initial measures of institutional quality in host countries have tended to use only a single dimension of institutional variables. This study has significant limitations: even if two countries have the same level of rule of law governance, if they have very different levels of democracy, government efficiency, etc., and thus different guarantees of contract enforcement, this can have a very different impact on investment flows.

In subsequent studies, scholars began to consider combining the six indicators of the WGI into a single indicator by taking a weighted average. This problem can be solved by combining the six dimensions of the WGI into one indicator using principal component analysis rather than averaging.

Both direct averaging and principal component analysis are vague and use a composite index - "quality of the host country" - to evaluate the impact on China's OFDI, making it difficult to know whether it is the rule of law environment, democratic system, or government efficiency. It is difficult to know whether it is the rule of law environment, the democratic system, or the efficiency of the government that affects the location choice of China's OFDI. To address this issue, some scholars have studied the impact of six indicators on China's FDI, and Wang Jian and Zhang Hong (2011) found that government effectiveness was significantly positively related to China's OFDI flows, while corruption

control was significantly negatively related to China's OFDI flows, and the other four indicators had no effect.

3. The impact of absolute institutional quality on OFDI

3.1 Viewpoint 1: Chinese OFDI is "institutional risk aversion"

To enter and survive in a host country, multinational enterprises need to gain recognition from the government, the market, and consumers, which means that they have to overcome obstacles in terms of legal constraints, market rules, and cultural values. A stable institutional environment in the host country can provide a safe and stable space for firms to develop and their property rights can be effectively protected, while in economies with poor institutional quality, the business environment is harsher and the expected benefits of OFDI are not guaranteed, hence the tendency of OFDI to be "risk-averse".

The Chinese OFDI tends to flow into countries with lower institutional risk, showing the characteristics of "risk aversion". OFDI in general prefers countries or regions with a stable political environment and high regulatory quality.

On the contrary, Yang et al (2016) find that China's OFDI is not risk-averse, but a biased illusion since outward investment is more often directed to regions with lower levels of economic development and richer natural resources^[1].

3.2 Viewpoint 2: China's OFDI is "regime risk-averse"

In contrast to the "institutional risk aversion" argument, the "institutional risk preference" argument states that there is a "lubricating effect" of institutional deficiencies, whereby poor institutional quality can somehow mitigate the effects of procedures, processes, and other regulated institutional products. Scholars of the "institutional risk preference" theory argue that China's OFDI prefers countries and regions with a poor institutional environment and high political risk, which can be explained by scale advantage and non-market skills. This phenomenon can be explained by scale advantage and non-market skills.

One reason why multinational enterprises tend to invest in countries (regions) with poor institutional environments is that Chinese multinational enterprises have institutional and scale advantages. The scale advantage is reflected in the fact that China is the second largest economy, with large foreign exchange reserves and sufficient capital support. The institutional advantage is reflected in the "Go Global" strategy and the "One Belt, One Road", which provide policy support and improve the lack of competitive advantage in the home country due to institutional weaknesses. Chinese enterprises have specific advantages in many developing countries with imperfect systems due to institutional and scale advantages.

Second, multinational firms tend to invest in countries (regions) with a less favorable institutional environment because Chinese multinational firms are more inclined to acquire non-market skills. A country's institutional environment can give multinational firms both market skills, which refer to the technology and management processes needed to sustain a firm's productive activities and non-market skills, which refer mainly to the ability to use non-market means to make a profit. The ability of firms to acquire non-market skills is magnified, and non-market resources are used to build up a 'comparative advantage' in competition. In the less developed institutional environment of the host country, Chinese MNEs tend to acquire non-market skills and choose appropriate production methods to reduce costs based on path dependence.

Qiu and Yang (2015) find that the preference for location factors varies across ownership, with SOEs preferring to enter countries with higher political risk, while private firms prefer to enter countries with political stability^[2]. Moreover, SOEs enjoy more policy support and preferences, especially in China's immature capital market structure, which makes it easier for them to obtain financing and less constrained by capital. Therefore, Chinese OFDI, dominated by SOEs, is characterized by "institutional risk preference".

3.3 Viewpoint 3: Country Heterogeneity Analysis

It is too absolute to say in general that Chinese OFDI is "institutional risk preference" or "institutional risk aversion", because China does not have the same institutional preference for all countries, and not

all Chinese enterprises have the same institutional risk preference. To provide a more realistic picture of the geographical distribution of OFDI in China, it is necessary to analyze country heterogeneity and firm heterogeneity.

Wen and Yang (2021) did both host country heterogeneity, east-west China regional heterogeneity, firm size heterogeneity, and industry heterogeneity for the analysis^[3]. The results of the host country analysis show that Chinese investment in OECD countries values government efficiency and regulatory quality more, while investment in non-OECD countries (regions) values a stable political environment. Industry heterogeneity analysis shows that all major industries show a preference for countries or regions with higher institutional quality.

4. Institutional distance and absolute institutional quality

While institutional quality captures the unilateral institutional differences between host and home countries, institutional distance focuses more on the bilateral institutional differences between host and home countries. The introduction of "bilateral institutional distance", rather than simply considering the institutional environment of the home country, allows for more accurate measurement of bilateral international investment flows due to institutional factors. The reason for this is the "institutional duality" that firms face in the investment process: on the one hand, to gain and maintain legitimacy in the host country, they need to be subject to the isomorphic pressures of the local institutional environment; on the other hand, they have to accept the internal consistency of uniform practices from the home country. Therefore, considering the institutional distance formed by bilateral institutional differences can more realistically reflect the costs and risks faced by enterprises in the outbound investment process.

5. Measurement of institutional distance

Since institutional distance is the difference between the quality of bilateral institutions, the measurement of institutional distance is based on the measurement of institutional quality. It is only that different scholars have adopted different mathematical treatments to measure the gap in bilateral institutional quality.

A common approach is to use the six dimensions of the Global Governance Indicators (GGI) to measure the institutional distance between China and the host country using the KSI index method, and Tian (2021) introduces principal component analysis to combine the six indicators of the WGI into one indicator, with the political-institutional distance being the absolute value of the difference between the principal component indicators of the political system of China and the host country^[4]. The absolute value of the difference between the two countries institutional quality reflects the bilateral institutional distance.

To overcome the shortcomings of a single indicator in reflecting institutional distance, a comprehensive country-specific institutional distance proxy variable can also be constructed from four dimensions: legal institutional distance, macroeconomic institutional distance, microeconomic institutional distance, and political institutional distance.

6. Impact of institutional distance on OFDI

There are three different views on the impact of institutional distance on OFDI, one is the institutional escape theory, the other is the institutional proximity theory, and the third is based on the heterogeneity discussion.

6.1 Institutional Escape Theory

The institutional flight theory argues that multinational companies will choose to invest in countries with systems that are more different from their home countries and that there is a so-called "institutional risk preference paradox".

In the case of developing countries, when the institutional quality of developing countries is poor, the intellectual property rights of enterprises cannot be effectively protected, and the government is inefficient. When the cost of doing business due to the country's outdated political system exceeds the cost of doing business across borders, firms will choose to invest across borders in the early stages of

growth to escape the constraints of domestic institutional weaknesses, and when investing in host countries with better institutions, multinational firms can take advantage of the 'outsider advantage' to exploit institutional arbitrage.

According to Jiang and Jiang(2012), for developing economies, the worse the domestic institutional environment and the greater the institutional distance from the host country, the more firms expect to circumvent the constraints of the backward domestic system through OFDI^[5]. Through the "learning effect", China can gain access to the diversified and potentially valuable resources of the host country, thus giving it a latecomer advantage and improving its international competitiveness.

6.2 Institutional proximity theory

In contrast to the institutional flight theory, the institutional proximity theory suggests that institutional distance is negatively correlated with OFDI; the greater the institutional distance, the higher the "foreign operating cost", and the more significant the disadvantage of outsiders.

According to Deng (2012), the greater institutional distance increases the costs of searching for markets, familiarising oneself with the host market environment, negotiating investments, and ensuring contractual performance, thus reducing the expected rate of return on investment^[6]. Therefore, to avoid the higher costs and risks associated with greater institutional distance, and to avoid the disadvantages of being an outsider, firms tend to invest in countries with a similar institutional structure. The greater the institutional distance, the more difficult it is for multinational enterprises to obtain internal and external legitimacy, and thus their OFDI process will be hindered. China's OFDI is characterized by both "political proximity" and "economic flight", and is influenced by comparative advantages, investment costs, and risks. The willingness to invest is stronger in countries with more distant economic and less distant political systems.

6.3 A discussion based on heterogeneity

In the same way that it is too absolute to say that Chinese OFDI is "institutional risk-averse" or "institutional risk-averse" when discussing institutional quality, it is also necessary to analyze the heterogeneity of the institutional distance dimension when analyzing the impact of institutional distance on Chinese OFDI.

When looking at the different dimensions of institutional distance, China tends to choose host countries with regulatory quality and rule of law levels that are more different from its own, as well as host countries with government efficiency, political stability, and political systems that are similar to its own.

Li et al (2020) consider the political and cultural institutional distances, which promote China's OFDI to countries along the Belt and Road, while cultural distance has the opposite inhibiting effect, and the inhibiting effect of cultural distance is significantly greater than the promoting effect of institutional distance, with cultural distance being more important than institutional distance^[7]. By dividing institutional distance into the positive institutional distance (host country institutional quality is better than that of the home country) and negative institutional distance (host country institutional quality is worse than that of the home country), China's investment in countries along the Belt and Road shows an overall "institutional proximity" characteristic. The impact of institutional distance on OFDI differs from one direction to another, with negative institutional distance not having a significant impact, while positive institutional distance hinders OFDI.

7. Review of the literature and summary

From the above literature, it can be seen that there are two main research directions on the impact of institutional quality and institutional distance on OFDI in China. One, institutional quality or institutional distance is used as the core explanatory variable to explain the impact of institutional factors on OFDI in China; the other, the interaction term between institutional factors and other factors is introduced to analyze the moderating effect of institutional factors.

However, there is no definitive conclusion on the role of institutional quality and institutional distance on China's OFDI. The reasons for the different findings among different scholars may lie in: firstly, the inconsistency in the selection of sample countries or sample industries; secondly, the inconsistency in the measurement methods of the core explanatory variables regime and institutional distance.

Therefore, this paper argues that a heterogeneity analysis is necessary when analyzing the impact of institutions on OFDI and that the heterogeneity perspective needs to be refined as much as possible to avoid portraying the impact of an overall and generalized "institutional quality" or "institutional distance". The impact of the institutional environment. The impact of institutional factors on OFDI in a particular sector should be the focus of future research, both in terms of countries and sectors and specifically in terms of the impact of institutional factors in a particular type of host country. In this way, the inconsistency of findings resulting from the use of "holistic" evaluation criteria can be avoided.

Secondly, the paper argues for a more comprehensive selection of indicators to measure the quality of host country institutions or the distance between bilateral institutions, to avoid missing variables. In the process of OFDI, enterprises face not only political, economic, and cultural institutional environments, but also other factors such as whether the two sides share a border, whether they have signed a trade agreement, and whether they identify with China and Chinese culture, which are all institutional costs that enterprises face in the process of OFDI. Therefore, this paper argues that establishing a more comprehensive measure of institutional quality should be the focus of future research.

Overall, a more refined and comprehensive study of the impact of institutional factors on OFDI in China should be the focus of future research.

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