In the Eye of the Beholder: Institutions, Political Risk, and China’s Multinational Corporations

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IPES Annual Conference
November 2, 2018
Motivation

Growing importance of FDI from emerging markets

China is the largest investor among emerging economies and second overall
Empirical Puzzle

- Political risks in host countries strongly associated with Chinese FDI (Buckley et al., 2007).

- China invests heavily in “pariah states” (Foreign Affairs, 2008).

- Chinese investors particularly attracted to countries rich in natural resources but with poor institutions (Kolstad & Wiig 2012).

- Yet, all existing studies rely on aggregate FDI flow data or anecdotal observation, and thus provide little insight into how Chinese MNCs perceive and respond to political risks.
How do Chinese MNCs perceive political risk and political institutions in host countries?

- Focus on policy uncertainty and regime type
Political Risk & EMMNCs

- Home-country embeddedness $\Rightarrow$ political capabilities (ownership advantages) $\Rightarrow$ less sensitive to political risk or even risk-prone.

- We argue that:
  - Risk mitigation strategies in weak institutions often extra-institutional (e.g., building political connections)
    - Firms lack institutionalized access to policy-making.
    - Lack of credible commitment $\Rightarrow$ high risk of reneging on agreed-upon policies.
  - Not transferrable because they are context-specific.

Hypothesis 1: Chinese MNCs are sensitive to political risks in host countries.
Regime Type & EMMNCs

- Democratic advantages
  - Checks and balances, credibility, political constraints, rule of law, etc. (e.g., Ahlquist 2006; Jensen 2003, 2006; Li & Resnick 2003)

- Autocratic advantages
  - Monopoly rents (e.g., Li & Resnick 2003; Wright & Zhu 2018).
  - Institutional familiarity (e.g., Athreye and Kapur 2009; Holburn & Zelner 2010).

H2a: Chinese MNCs favor authoritarian countries.

H2b: Chinese MNCs favor democratic countries.
A vignette experiment w/ 2×2 factorial design:

- Regime type: democracy versus autocracy.
- Confounding in observational studies.

<table>
<thead>
<tr>
<th>Democratically Elected Govt.</th>
<th>Policy Stability</th>
<th>Adjusted frequently</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Demo w/ Policy Stab.</td>
<td>Demo w/ Policy Instab.</td>
</tr>
<tr>
<td>No</td>
<td>Auto w/ Policy Stab.</td>
<td>Auto w/ Policy Instab.</td>
</tr>
</tbody>
</table>
Description of Vignettes

“Country X is a middle income developing country with a population of 30 million. For the past three years its economy has grown at 4.5% per year on average. The leader of this country is/is not democratically elected. In the past few years, the country’s currency, fiscal, taxation, and tariff policies have been stable/adjusted frequently.”
Experimental Design

- Firm executives randomly assigned one of the four vignettes.

- Firstly asked to rate the above business environment.
  1. Very bad  
  2. Bad  
  3. Fair  
  4. Good  
  5. Very good

- Secondly asked about how they would like to invest.
  1. Wholly owned subsidiary;  
  2. Majority-owned joint venture;  
  3. Minority-owned joint venture;  
  4. Equity investment;  
  5. No investment;  
  9. Cannot answer
China Outward Direct Investment Survey (CODIS)

- A business survey of the risk perceptions and investment strategies of Chinese outward investors.

- 2014 module implemented between June and October 2014 in collaboration with CCPIT & Tsinghua University.
  - 601 responses in total.
  - A mix of random and convenience samples.
    - Results are consistent and robust with post-stratification weights.
Perceived Attractiveness of Business Environments (Pooled Results)
Policy Stability vs. Policy Instability

Diff = 0.78 (p = 0.00)
Democracy vs. Autocracy

![Graph showing the comparison of attractiveness of business environments between Autocracy and Democracy. The graph indicates a difference of 0.37 with a p-value of 0.00.](image-url)
Domestic vs. Overseas Investors

![Graph showing perceptions of business environments for domestic-oriented firms and overseas investors across different political stability and autocracy conditions.]
Market Entry Decisions (Overseas Investors Only)
Conjoint Analysis

- Embedded in the 2015 Module of CODIS
  - Two economic attributes
  - One regime attribute
  - Four political risk attributes

<table>
<thead>
<tr>
<th>Macroeconomic conditions</th>
<th>Stable/Unstable</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-Year Average Growth Rate</td>
<td>Negative/Little/Moderate/High</td>
</tr>
<tr>
<td>Selection of Political Leaders</td>
<td>Democratically/Non-Democratically Elected</td>
</tr>
<tr>
<td>Expropriation Risk</td>
<td>Almost None/Some</td>
</tr>
<tr>
<td>Demand for Unofficial Payments</td>
<td>Seldom/Frequent</td>
</tr>
<tr>
<td>Policy Consistency</td>
<td>Low/Moderate/High</td>
</tr>
<tr>
<td>Risk of Armed Conflict</td>
<td>Low/Moderate/High</td>
</tr>
</tbody>
</table>
**Illustration of the Conjoint Experiment**

<table>
<thead>
<tr>
<th>Macroeconomic Conditions</th>
<th>Country [A] is a developing country and open to foreign investment</th>
<th>Country [B] is a developing country and open to foreign investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-Year Economic Growth Rate</td>
<td>Stable &amp; Little Volatility in Growth Rates</td>
<td>Stable &amp; Little Volatility in Growth Rates</td>
</tr>
<tr>
<td>Selection of Government Leader</td>
<td>Moderate</td>
<td>Negative</td>
</tr>
<tr>
<td></td>
<td>Democratically Elected</td>
<td>Non-Democratically Elected</td>
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<td>Demand for Unofficial payments</td>
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<td>Frequent</td>
</tr>
<tr>
<td>Policy Consistency</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Risk of Armed Violence</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

“If your company were going to invest in these two countries, which one is more attractive?”

1. Country A
2. Country B
Conjoint Analysis Results

- Macroeconomic Conditions:
  - Unstable
  - Stable

- 5-Year Average Growth Rate:
  - Negative
  - Little
  - Moderate
  - High

- Democratically Elected Government:
  - No
  - Yes

- Expropriation Risk:
  - Almost None
  - Some

- Demand for Unofficial Payments:
  - Seldom
  - Frequent

- Policy Consistency:
  - Low
  - Moderate
  - High

- Risk of Armed Violence:
  - Low
  - Moderate
  - High

Effect on Pr(Preferred Business Environment)
Conclusion

Findings:
- Policy instability matters more than regime type per se.
- Chinese investors are sensitive to political risk in host countries, e.g., expropriation & policy instability.
- Contrary to the popular perception that Chinese investors favor pariah states, they have no preference for authoritarian countries.
  - A slight preference for democracies.

Contributions
- First experimental study of Chinese MNCs and political risk.
  - Shed light on the behavior of Chinese investors.
- Add to the debate on regime type and FDI in two ways:
  - Contribute direct evidence from firm executives.
  - Regime type weighted less than specific political risk.