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A Review of the Literature on Chinese OFDI, Institutional Environment, and Institutional Distance

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Abstract

Researchers mostly utilize the World Governance Indicators (WGI) to quantify institutional quality and bilateral institutional distance because there is currently no widely acknowledged way to compute institutional distance or quality. The influence of the bilateral institutional environment on China's OFDI is not consistent when it comes to institutional quality; in fact, opinions vary. This paper looks at the relationship between absolute institutional factors and bilateral institutional distance as well as the location choice of Chinese OFDI. There are notions of institutional risk aversion and preferences when it comes to institutional distance, and conceptions of institutional escape and intimacy when it comes to institutional excellence. As research progresses, more and more academics are realizing how important it is to perform heterogeneity assessments of different countries, local firms, etc.

Introduction

Since the implementation of the "going out" policy during the reform and opening up, China's foreign investment has increased significantly. The reason for this is the steady acceleration of the "going out" approach. Chinese companies' outward foreign direct investment (OFDI) has a huge development potential thanks to the "going out" strategy. Between January and August 2022, China's outbound sector-wide direct investment was

RMB 621.87 billion, up 2.4% year over year, according to data from the Department of Foreign Investment and Economic Cooperation of the Ministry of Commerce of China. With stock sizes of USD 772.71 billion and USD 2,565.29 billion, respectively, the United States and the Netherlands rank first and second internationally in terms of OFDI stock size. China rounds out the top three nations. According to the World Investment Report 2020, there were USD 34.6 trillion in worldwide OFDI assets as of the end of 2019. China's external FDI stock remained stable relative to the rest of the world. As to the 2019 China outbound FDI Statistical Bulletin, China's outbound FDI stock was at US$219.88 billion at the end of 2019, signifying 6.4% of the global share. Due mainly to the New Crown Pneumonia pandemic, which has spread over the world and hastened the reconfiguration of the global political and economic environment, the world is today undergoing a profound transition not witnessed in a century. Along with the global economy, there has been a fall in global cross-border direct investment, a rise in protectionism and unilateralism, a weakening of the conventional international cycle, and an intensification of reverse globalization. These elements have all had a major effect on the external environment that Chinese companies doing business abroad must contend with. In response to the turbulent external environment and a century of significant changes in the political and economic landscape of the world, China has proposed a "double-circle" strategy to build a new development pattern in which "the major domestic cycle is the mainstay and the domestic and international cycles promote each other". Creating new advantages that will allow China to compete and work with other countries in the new environment is the task. Market reasons were once thought to be the primary element affecting Chinese OFDI's choice of site, i.e., however, there is a notable "blind pile-up" in China's OFDI location selection process, and the failure of multinational corporations to consider institutional differences in their OFDI location selection has resulted in a number of missteps that have made it more difficult for Chinese businesses to "go global." Resource or strategic searching was the main impetus for Chinese OFDI. Researchers have found that, in addition to market parameters like market size, resource

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endowment, technology level, and inflation rate, non-market features of the host nation, such as the institutional environment and varied institutional distances, also have an influence on OFDI. This is especially true as China's foreign direct investment (FDI) expands in magnitude and geographic diversity. The institutional environment is often seen as a potential expense affecting MNCs' decision to engage in foreign direct investment (OFDI); nevertheless, the location factors affecting OFDI in China are becoming increasingly complex. Additionally, analyzing the impact of market conditions on OFDI alone is excessively skewed. Institutional variables, such as political, economic, and cultural features, are increasingly influencing the placement and flow of foreign direct investment (FDI) from China. The association between absolute institutional quality and OFDI, as well as the relationship between relative institutional distance between two nations and OFDI, have been the focus of previous research on the influence of institutional characteristics on OFDI location choice.

2. Three common indicators are used to assess the quality of an institution: "Formal institutions" consist of legal requirements and economic restrictions, whereas "informal institutions" are composed of behavioral norms and conduct codes. The following criteria are used to evaluate the quality of institutions, which are frequently categorized as political, economic, or cultural institutions.

(1) Political system quality

The six characteristics of government effectiveness, political stability, rule of law, regulatory quality, and government accountability are measured by the World Governance Indicators (WGI), which are used to evaluate the quality of political systems. This indicator comes from the World Bank.

(2) Economic system quality

The economic system's quality is measured by the Economic Freedom Index (EFI). The EFI is composed of ten components: the banking industry, wages and prices, government

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regulation, information markets, foreign investment, trade policy, government fiscal burden, government intervention in the economy, monetary policy, and capital flows. This ranking system, which has been in place since 2007, indicates a more open economy with higher scores on the percentage scale. The information used in this index came from the Heritage Foundation.

(3) Cultural institution quality

The system's overall quality is measured using the Hofstede Cultural Dimensions. The six cultural dimensions of rights are as follows: avoiding ambiguity; individualism vs collectivism; masculine versus feminine; long-term versus short-term orientation; permissiveness versus limitation. The cultural dimension metrics for every country were available on the Hofstede website.

Application of institutional quality measures

Traditionally, evaluations of the host countries' institutions' quality have been based on a single institutional variable. There are significant limitations to the study. More specifically, there may be notable differences in investment flows but not in government efficiency or guarantee of contract enforcement between two countries with comparable degrees of democracy and governance. Subsequent studies began considering averaging the six WGI indicators to produce a single index. This issue might be handled by combining the six WGI dimensions into a single indication using principal component analysis as opposed to averaging. Because both principal component analysis and direct averaging are imprecise and use a composite indicator called "quality of the host country" to measure the influence, it is difficult to determine whether the factor influencing China's OFDI is the democratic system, the environment of rule of law, or the effectiveness of the government. Some academics have looked at the connection between China's foreign direct investment (FDI) and six variables in order to address this problem. They discovered that whereas corruption

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control was strongly adversely correlated with China's OFDI flows, government effectiveness was significantly favorably correlated with them. The remaining four indications were inert. Which of the three factors government efficiency, rule of law environment, or democratic system influences China's OFDI placement decisions is difficult to ascertain.

The impact of absolute institutional quality on OFDI

Viewpoint 1:

Chinese OFDI is "institutional risk aversion" To enter and prosper in a host country, multinational corporations must get past regulatory barriers, market norms, and cultural expectations as well as legal requirements. Because the business climate is more difficult and the expected advantages are not always assured in economies with poor institutional quality, foreign direct investment (OFDI) has a tendency to be "risk-averse". On the other hand, businesses may grow in a secure and stable climate in the host nation where their property rights can be adequately safeguarded. Chinese FDI demonstrates characteristics of "risk aversion" as it favors countries with lesser institutional risk. In general, OFDI supports countries or regions with robust legal frameworks and stable political systems. However, Yang et al. (2016) find that because China's outward foreign direct investment (OFDI) is mostly concentrated in regions with superior natural resources and lower levels of economic development, it is not risk-averse but rather a distorted illusion.

Viewpoint2:

China's OFDI is "regime risk-averse" According to the "institutional risk preference" argument, institutional flaws have a "lubricating effect," which means that they could unintentionally mitigate the effects of regulated practices, processes, and other institutional products. This is in opposition to the "institutional risk aversion" theory. The "institutional risk preference" theory holds that China prefers countries and regions with weak

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institutional frameworks and high political risk because of its size advantage and non-market capabilities. This phenomenon can be explained by scale advantage and non-market talents. Chinese multinational businesses seek to invest in countries or regions with weak institutional frameworks because of their institutional and scale advantages. China's economy, which is the second largest in the world, benefits from its size advantage since it has sufficient financial support and huge foreign exchange reserves. Manifestations of the institutional advantage include the "Go Global" strategy and the "One Belt, One Road" programs, which provide governmental backing and lessen the loss of competitive advantage in the home nation brought on by institutional deficiencies. Chinese enterprises have a clear advantage in many developing countries with weak institutions because of institutional and size advantages. Second, Chinese multinational enterprises often invest in countries (or regions) with less welcoming institutional settings because of their inclination to obtain non-market competencies. The institutional framework of a country may provide multinational businesses with both market skills and non-market skills. Market skills are the technology and management procedures needed to support a business's productive operations. Non-market skills are the ability to use non-market approaches to earn profit. Companies may now acquire non-market skills more easily, and they can use these non-market assets to provide them a "comparative advantage" over rivals. In the less developed institutional environment of the host country, Chinese multinational enterprises (MNEs) often use production practices based on path dependence and create non-market capabilities to save costs. Private corporations wish to enter nations with political stability, whereas State-Owned Enterprises (SOEs) choose to enter those with more political risk. These preferences for location factors vary based on ownership, according to Qiu and Yang (2015). Additionally, SOEs gain from increased official backing and preferences, particularly in China's emerging capital market structure, which makes it easier for them to acquire funding and lessens financial limits. Consequently, Chinese OFDI, which is governed by SOEs, is characterized by "institutional risk preference".

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Viewpoint 3

Country Heterogeneity Analysis

It is too general to say 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. Only by examining business and national heterogeneity can the regional distribution of OFDI in China be more accurately represented. Wen and Yang (2021) addressed regional heterogeneity in east-west China, industry heterogeneity, host country heterogeneity, and firm size heterogeneity in their analysis[3]. The results of the host country study show that Chinese investment in OECD countries prioritizes stable political settings, effective governance, and high-quality regulations more highly than Chinese investment in non-OECD nations or areas. An industry heterogeneity analysis shows that all major sectors show a preference for countries or locations with higher institutional quality.

4. While institutional quality generally represents the unilateral institutional inequalities between the home and host nations, absolute institutional quality and institutional distance focus more on the bilateral institutional differences between the two. The concept of "bilateral institutional distance," which goes beyond just considering the institutional environment of the host country, enables more accurate evaluation of bilateral international investment flows deriving from institutional factors. This is due to the "institutional duality" that companies face during the investment process: in order to establish and maintain legitimacy in the host country, companies must accept the internal consistency of uniform practices from their home country while also giving in to the isomorphic pressures of the local institutional environment. As a result, accounting for the institutional distance brought about by bilateral institutional discrepancies might help to better depict the costs and risks that companies face when making outbound investments.

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Evaluation of Institutional Distance:

The evaluation of institutional distance establishes the difference in quality between the two institutions based on the assessment of institutional quality. The only distinction is that other studies have computed the variation in bilateral institutional quality using different mathematical methods. The political-institutional distance is the absolute magnitude of the difference between the principal component indicators of the political systems in China and the host nation. Tian (2021) uses principal component analysis to integrate the six indicators of the WGI into a single indicator[4]. One popular way is to utilize the KSI index method to calculate the institutional distance between China and the host nation using the six aspects of the Global Governance Indicators (GGI). The absolute magnitude of the institutional quality difference between the two countries reflects the bilateral institutional distance. The four aspects of legal institutional distance, macroeconomic institutional distance, microeconomic institutional distance, and political institutional distance can also be used to construct a comprehensive country-specific institutional distance proxy variable. By doing this, the shortcomings of using only one indicator to represent institutional distance will be lessened.

6. The institutional escape theory, the institutional proximity theory, and the heterogeneity discussion-based perspective are the three different viewpoints that address the connection between institutional distance and OFDI.

Institutional Escape theory:

This theory postulates that there is an "institutional risk preference paradox" that will lead to multinational companies seeking to make investments in countries where the systems are more unlike from their own. Insufficient institutional underpinnings in emerging nations lead to inadequate protection of enterprises' intellectual property rights and ineffective governance. During their early phases of expansion, when the cost of doing business in the

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home country's outmoded political system is higher than the cost of doing business globally, businesses will choose to invest abroad in order to avoid the limits of domestic institutional shortcomings. Moreover, when international corporations invest in host nations with better institutions, they can take advantage of institutional arbitrage by using the 'outsider advantage'. According to Jiang and Jiang (2012), the weaker the institutional environment at home and the larger the institutional distance from the host nation, the more probable it is that firms in developing countries will anticipate using OFDI to get past the constraints of their home system[5]. By tapping into the host nation's varied and potentially lucrative resources, China may leverage the "learning effect" to acquire a competitive edge over its competitors and improve its standing internationally.

The institutional proximity theory argues that institutional distance and OFDI are negatively correlated, in contrast to the institutional flight theory. A greater institutional distance is associated with a higher "foreign operating cost" and a more pronounced disadvantage for outsiders. According to Deng (2012), a greater institutional distance reduces the expected rate of return on investment by increasing the cost of doing market research, getting to know the host market, negotiating deals, and ensuring contractual compliance[6]. In order to avoid the higher costs and risks associated with greater institutional distance as well as the disadvantages of being an outsider, corporations thus want to invest in countries with comparable institutional systems. The farther apart institutionally multinational firms are from one another, the more difficult it will be for them to get both internal and external legitimacy, which will hinder their OFDI process. China's foreign direct investment (FDI), which is influenced by risks, investment costs, and comparative advantages, is characterized by both "political proximity" and "economic flight". Countries with more distant economic systems and less distant political systems tend to have stronger investment inclinations.

6.3 A heterogeneous discussion in the same way that it is not appropriate to draw the absolute conclusion that Chinese FDI is "institutional risk-averse" or "institutional risk-

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averse" in relation to institutional quality, it is also important to consider the heterogeneity of the institutional distance dimension when analyzing how institutional distance affects FDI from China. When looking at the many aspects of institutional distance, China tends to choose host countries that are more comparable to its own political systems in terms of political stability, government effectiveness, and regulatory quality as well as higher than it is in terms of rule of law and regulatory quality. Institutional distance inhibits, but cultural distance has the reverse impact and substantially more inhibits than promotes. Cultural distance is more significant than institutional distance, according to Li et al. (2020), who also believe that institutional gaps, both political and cultural, support China's OFDI to nations along the Belt and Road[7]. By classifying institutional distance into positive institutional distance (the host country's institutional quality is higher than the home country's) and negative institutional distance (the host country's institutional quality is lower than the home country's), China's investments in the countries along the Belt and Road exhibit an overall "institutional proximity" characteristic. The impact of various institutional distances on OFDI varies; whereas negative institutional distance has no appreciable effect, positive institutional distance precludes OFDI.

Conclusion

It is clear from the literature discussed above that there are two main research directions that look at the relationship between institutional quality and distance and foreign direct investment (OFDI) in China. Institutional quality and institutional distance are the two key explanatory variables that explain the influence of institutional factors on OFDI in China. An interaction term between institutional elements and other factors is included in order to investigate the moderating influence of institutional factors. However, it is still unclear how institutional distance and quality affect China's OFDI. Two things might lead to scholarly disagreement: first, different approaches to selecting nations or industries for the sample,

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and second, different approaches to evaluating the two primary explanatory variables, institutional distance and regime.

This paper argues that to avoid portraying the impact of an all-encompassing and generalized "institutional quality" or "institutional distance," a heterogeneity analysis is necessary when analyzing the impact of institutions on OFDI, and that the heterogeneity perspective needs to be refined to the greatest extent possible. the impact of institutional settings. Future research should focus on how institutional variables impact foreign direct investment (FDI) in a particular industry, as well as how these factors affect other countries and sectors. More specifically, it should be investigated what sort of host country a certain institutional aspect impacts. This will assist in avoiding the uneven outcomes that arise from employing "holistic" assessment criteria. The paper also argues for a wider range of measures when evaluating the quality of institutions in the host country or the distance between bilateral institutions in order to avoid overlooking elements. Enterprises have to cope with additional variables related to OFDI in addition to political, economic, and cultural institutional settings. These include the extent to which the businesses identify with China and its culture, trade agreements, and border sharing. All of these expenses are related to the OFDI procedure. Therefore, this paper argues that the focus of future research should be on creating a more comprehensive institutional quality measure. All things considered, further in-depth and sophisticated examination of the institutional components influencing OFDI in China need to be the focus of future study.

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