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The Role of Informal Institutional Risks on Firm Performance in Emerging Market Economies

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Abstract

This study aims at empirically examining the effects of informal institutional risks on the performance of more than 12000 firms in 39 emerging market economies. This study examines the influence of informal institutional risks, along five dimensions of cultural values, on firm performance. The results reveal that different cultural dimension have differential effects on firm performance. The findings show that while long-term orientation cultural value positively promote firm performance, other cultural values such as uncertainty avoidance, individualistic and masculinity negatively affect performance of firm in emerging market. However, the study further reveals when quality of informal institutions are measured by the extracted two-unique (uncorrelated) cluster cultural measure and alternatively by social capital they all have positive influence on firm performance. This highlights and provides caution on past research not to oversimplify on the roles play by different cultural values in influencing firm performance in emerging markets. They can have unique combined influence on firm performance which firm managers should take into account when devising strategies to boost the performance of their firms.

Keywords: Host's Institutional environment, Firm performance uncertainty avoidance (UA), Individualism, Masculinity, Long term orientation, Hofstede cultural components.

1. Introduction

In international business (IB), one of the risks that firms face is institutional risks, a risk that embeds in the host/destination countries. Since firms' strategic decisions and management are undertaken in such institutional environments, the quality of that environment could influence firms' performance. Therefore, understanding the host-countries' underlying institutional environment becomes an important ingredient for successful market entry and performance. Consequently, the importance of underlying institutions in influencing firm performance has been one of the main focuses and significance in IB research (Peng et al., 2008; Henisz and Swaminathan, 2008; Griffith, Cavusgil and Xu, 2008).

Recent literature points to the important role of recipient countries' political risk in effecting multinational firms only focus on one aspect of institutional risks (i.e. political risks or cultural diversities) fall short of providing a comparative analysis (Kobrin, 1979; Miller, 1992; López-Duarte and Vidal-Suárez, 2010) on culture of host-country's institutional risks. Culture of countries' risks have increasingly emerged as one of the recent international business research agenda (Henisz and Swaminathan, 2008; Griffith et al., 2008; Peng et al., 2008).Though political risk is important, it is just one aspect of formal institutions. the role of informal

institutional risks and cultural diversities are highly important for business performance, but overwhelming recent research focuses only on its impacts on firm strategic decision on the mode of entry into host country markets. A recent study found that these cultural diversities (i.e. informal institutions) determine bank-earning performance in the pre- and post-financial crisis (Kanagaretnam et al., 2011). The impact of cultural diversities on foreign firm performance is found to be much lacking in recent studies. This research aims at filling these gaps in both focusing on aggregate and disaggregate cultural diversity and how interact in influencing firm performance in emerging countries.

The general question of this study is: can culture factor affect firm performance? For informal institutions, this study relies on culture to reflect the quality of informal institutions present in countries. This culture indicator has five sub-components that capture five separate values, namely individualism, masculinity, power distance, uncertainty avoidance, and long-term cultural orientations. Since these cultural values reflect different dimensions of culture (formal institutions), the present study would examine the effect of each component on firm performance. We also complement this analysis with another measure of informal institutions, the social capital. Measures of culture are taken from Hofstede or GLOBE variables (see, Kirkman et al., 2006; Venaik and Brewer,

2010) while the measure of social capital are taken from the data recently compiled by Lee et al. (2011). Based on evidences in the literature, the relationship between culture and firm's performance (see Fig. 1) is hypothesized as follow:
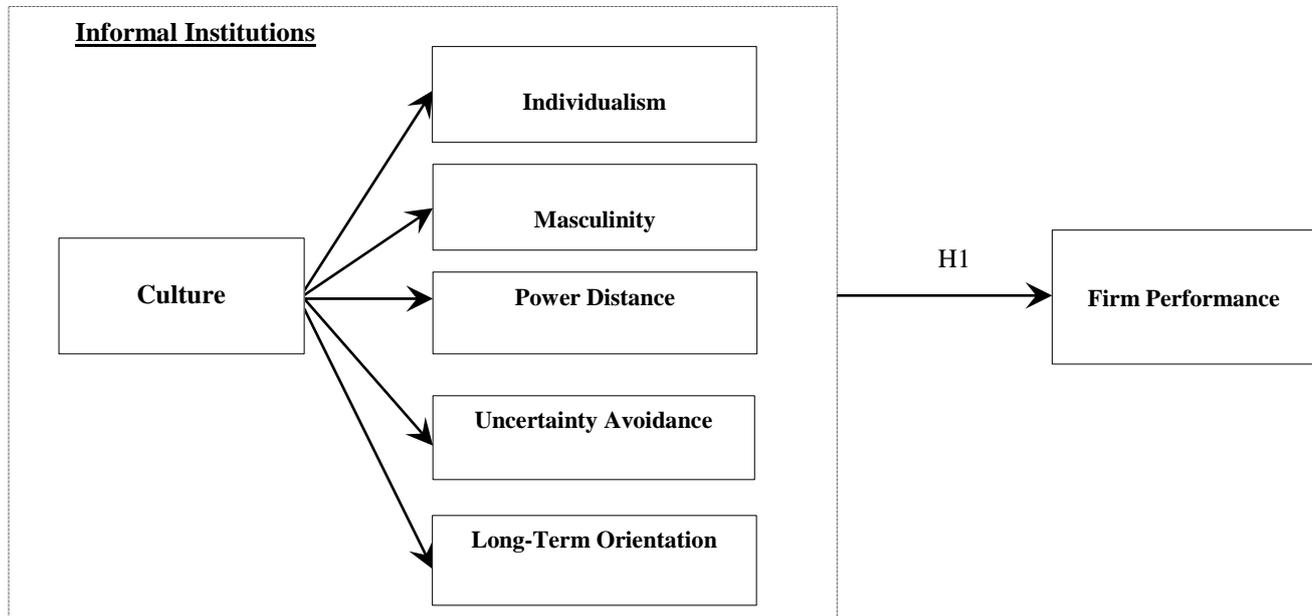
H1: High quality of informal institutional environment can positively influence firm performance.

Fig. 1. Study Framework

2. Theoretical Review

Theoretically, in the course of exchange or transaction, firms incur costs in terms of resources to acquire the information (information cost), negotiate the contracts (bargaining cost), and monitor the implementation/observance of the contracts (enforcement cost) (Williamson, 1985). Institutional environment defines these costs, hence better institutional qualities reduce the uncertainty and opportunistic behaviour (e.g. cheating, reneging on the contracts, expropriations by parties to the transaction) surrounding the business transaction, as opposed to the situation where institutions are of poor quality. The essence of this is that better qualities of "rule of the game" (i.e. North, 1990) would promote better business environment by reducing the transaction cost. Since firms are embedded in, and are influenced by, the countries' formal and informal institutions, these institutions not only drive the level of market competition but also influence the types of resources that firms are encouraged to produce (Peng, 2003; Porter, 1991; among others). In other words, since there are always different institutional contexts (that define degree of property rights protection and enforcement of the agreements or contracts) across different countries, there are differential costs to firms that perform in that environment. As North's definition of institutions quoted earlier indicates, informal constraints in the form of interpersonal trust among members of society, norms of behavior, conventions, culture, self-imposed codes of conduct, are important aspects of institutional infrastructure. Despite the

importance of private property rights and contracting institutions, international business literature mainly focuses on one aspect of institutions, namely political risks. In addition to political risk, recent studies show the important role of cultural and language diversities of the host countries in influencing international business, particularly the entry and performance of firms into foreign markets (López-Duarte and Vidal-Suárez, 2010; Meschi and Riccio, 2008; Lessard and Lucea, 2009; Keillor, Wilkinson, and Owens, 2005; Rothaermel, Kotha, and Steensma, 2006; Sanchez-Peinado and Pla-Barber, 2006; Slangen and van Tulder, 2009; Wan and Hoskisson, 2003; Miller, 1992; Haley, 2003). In what follows, the study first empirically reviews related literature that studies the effects of formal and informal institutions on firm entry mode. This is to provide a comparative look at the literature on the important role of institutions, and then a thorough review on the effect of institutions on performance is provided. In a related study, Li et al. (2012) sought to investigate the influence of informal institutions (culture of collective organizational value) on links between strategic alliance among firms and their performance. The authors provide empirical evidence, based on the sample of firms in the insurance industry in China, that JVs among similar firms tend to increase their accounting performance in terms of return on their asset compared to JVs among dissimilarity firms. Such positive connection becomes stronger when they possess higher degree of culture that value collective organizations. This evidence suggests that difference in informal institutions can also have a mediating influence on the performance of JVs firms.

In a similar study by Kanagaretnam, Lim, and Lobo (2011) only focus on the effects of cultural diversity on bank performance across sample of 39 countries during the period leading to global financial crisis (1993-2007) and during the period of crisis (2007-2008). The authors were particularly interested in finding out whether earning tendency among banks on two options, namely earning to just-meet-or-beat the prior period's earnings or income smoothing option, are affected by informal institutional environment underpinning the countries that the bank operates in. They found that culture matters in influencing bank earning option both during the pre and post-crisis periods. In the pre-crisis period, the results reveals that in countries which have high degree of individualistic values, masculine but low uncertainty avoidance tendency, bank earning tendency tends to opt for just-meet-or-beat the prior year's earnings. However, in countries having high degree of individualistic values, power distance but low uncertainty avoidance tend to have income smoothing earning option in their earning management. Further, during the crisis period, bank performance in these later cultural qualities tends to suffer heavy losses. The reasons are that such society's cultural value tends to encourage risk taking behaviours. Recently Stam et al. (2014) employed meta-analysis methods in an attempt to quantitatively synthesize and summarize the existing empirical evidence on the link between informal institutions particularly focusing on level of social capital and small firm performance across 59 studies with a sample size of 13,263. They found overall evidence indicating that social capital positively affects small firm performance. They highlight that this relationship is stronger for small firms with weak ties and network diversity (low social capital) operating in the advanced economies, while those operating in emerging economies record strong positive effects only for small firm with strong ties (i.e. high social capital).

3. Empirical Review

3.1 Data, Measurement and Methodology

Data. This section describes the variables and their measurement as well as the sources of the data. The firm's data is collected from World Bank's Enterprise Survey (WBES). Since 2002, World Bank has been conducting firm-level surveys through a face-to-face interviews with top general managers, managing directors, accounting managers, human resource managers, and business owners for over 130,000 companies in 135 countries across the globe. Each country was surveyed every three to four years with around 1,200 to 1,800 interviews were conducted for large economies (e.g. China), 360 interviews for medium size economies (e.g. Bangladesh, Sri Lanka), and 150 interviews for small economies (e.g. Latvia, Estonia). There are two part in WBES process. The first part is answered by top general managers, managing directors and business owners focused on issues of business environment, investment climates, and business strategy.

The second part, to be answered by accounting managers or personal managers, focuses on investment flows, products cost, firm performance and workforce statistics of the company.

This study selects 39 emerging economies comprising of the big emerging economies such as Brazil, Russia, India, and China (the so-called BRIC countries), Mexico, Indonesia, South Korea and Turkey, as well as other leading emerging economies as classified by International Monetary Fund (IMF), Standard and Poor (S&P), Dow Jones, and the Economist. The firm level data are currently available from 2002 to 2006. Ideally, recent information, for example 2011 or 2012, are preferred. But such information is not readily available as the World Bank Enterprise Survey project on thousands of firms across countries around the world start with different years since 2002 and take years before the current existing data were extracted. Researchers in this area use these data (see for example Wu, 2013; Yasar et al., 2011; among others). Table 1 provides a list of countries, the number of firms in each country and the year the survey were last conducted. In some countries, where WBES were conducted more than once, the latest year were chosen. In total, there are 31373 firms from service and manufacturing sectors, comprising industries such as food and beverages, garments and textile, electronics, Information Technology (IT), auto and auto components, metals and machinery, non-metallic and plastic materials, transport equipment, chemicals and pharmaceutics, accounting and finance, advertising and marketing, paper, wood and furniture, agroindustry, and others. However, since there are missing observations on the variables (e.g. firm performance measures) the final total observations are reduced to about 12888 firms.

Performance measure. There is no definitive measure of firm performance. In this study, we adopt labour productivity as our performance measure which is measured as output per labour. This measure reflects productivities performance of the firm (i.e. the amount of output that each employee produces on average). Study on the impact of institutions on firm's performance employ this measure among other alternatives and shows that it captures well the influence of institutions (see for example, Yaser et al., 2011). This is particularly relevant as these scholars pointed out that better quality institutions reduce two types of production costs faced by firms, namely transformation costs (the cost of production and processing) and transaction costs (e.g. costs of establish contracts and relations with other agents, of searching for appropriate trading partners and products, of negotiation, of monitoring and enforcing contracts) (Yaser et al., 2011, p.649).

This productivity performance measurement is preferred, because alternative measures such as accounting returns and stocks prices of the firms (capture the degree of firm's profitability) suffer from expropriation problem (Coff, 1999; Coff and Lee, 2003). This is because accounting returns and stocks prices are set after stakeholders have had an opportunity to try to extract above-market prices for their contributions, hence may not

reveal the true value generated by the firm's resources and capabilities (Wu, 2013, p.3). Nevertheless, accounting performance measure, i.e. firms' gross profits (equal to total revenues minus cost of the goods sold), is also employed for robust checks whether the finding on the links between institutions and firm performance change due to changes in performance measures. Although, firm profit is not a perfect measure it does capture degree of efficient performance of firms. Maximization of profit depend on least-cost and efficient methods in running the firms (e.g. operating and production). Thus, measuring firm performance through their profit allows one to assess how institutional risks, which is not the direct part of production process but the environment/setting within which such process takes place, shrink or increase the firm profitability. To construct our performance measures, the sales and cost variables were adjusted as follow before converting to

natural logarithmic value. For countries whose values were in thousands domestic currency unit (e.g. Philippines, Peru, Bangladesh, South Africa, Sri Lanka) we multiply them by 1,000 and then convert them into U.S. dollars (USD) using appropriate exchange rate (e.g. if the value is in 2006, the 2006 exchange rate is used). For some other countries, the values were in thousands of Euros (e.g. Vietnam), we also multiply them by 1,000 and convert them into USDs using appropriate exchange rate. Finally, when countries having values on the variables in thousand USDs (e.g. Romania, Slovenia, Turkey), we just multiply them by 1,000.

Firm's productivity and profitability are determined by both internal and external factors. As mentioned in the proceeding section, the independent variables are focal and controlled variables, which compose of both internal and external factors. Each of these determinant included in this study is discussed in detail below.

Table 1
List of countries and total number of firms

Country	Number of Firms	Year
Bangladesh	1001	2002
Brazil	1642	2003
China	2400	2003
Indonesia	713	2003
Pakistan	965	2002
Philippines	716	2003
Sri Lanka	452	2004
South Africa	603	2003
Egypt	977	2004
Senegal	262	2003
Morocco	850	2004
Malaysia	902	2002
Thailand	1385	2004
Vietnam	1150	2005
Mongolia	195	2004
Argentina	1063	2006
Colombia	1000	2006
Chile	1017	2006
Ecuador	658	2006
Mexico	1480	2006
Panama	604	2006
Peru	632	2006
Uruguay	621	2006
Venezuela	500	2006
Jordan	503	2006
Slovenia	223	2005
Poland	975	2005
Ukraine	594	2005
Hungary	610	2005
Czech Republic	343	2005
Romania	600	2005
Bulgaria	300	2005
Latvia	205	2005
Lithuania	205	2005
Estonia	219	2005
Russia	601	2005
Turkey	1323	2005
South Korea	598	2005
India	2286	2006

Notes: Year indicates the year that World Bank Enterprise Survey was conducted which correspond with available firm level data. When country was surveyed more than once, we take the latest year.

Measures of culture. The informal institutions in this study are measured by cultural diversity (CULT). These culture variable will be obtained from Hofstede (see for example, Venaik and Brewer, 2010; Kirkman et al., 2006).

According to Hofstede and Bond (1988: 6) culture is defined as "the collective programming of the mind that distinguishes the members of one category of people from those of another. Culture is composed of certain values,

which shape behavior as well as one's perception of the world." Hofstede' (2001) measures of culture compose of five components. As mentioned above, CULT compose of PD, UA, IND, MAS, and LTO. PD is defined as "the extent to which a society accepts the fact that power in institutions and organizations is distributed unequally" (Hofstede, 1980, 45). Furthermore, UA is defined as "the extent to which a society feels threatened by

uncertain and ambiguous situations and tries to avoid these situations by providing greater career stability, establishing more formal rules, not tolerating deviant ideas and behaviours, and believing in absolute truths and the attainment of expertise" (Hofstede, 1980, 45). On top of that, IND, i.e. individualism, is defined as "a loosely knit social framework in which people are supposed to take care of themselves and of their immediate families only" (Hofstede, 1980, 45). López-Duarte and Vidal-Suárez (2010) also adopted this strategy of measuring culture from Hofstede in their study on the impact of informal institutions on firm entry. In a further attempt below, we also explore whether each Hofstede cultural dimensions does really measure distinct cultural dimension for these emerging markets using correlation matrix and principle component factor analysis.

As Table 2 shows UA, PD and LOT are highly correlated (i.e. average of about 0.60) indicate that these dimension of CULT measure similar aspects of culture. Similarly, MAS and IND is also highly correlated (0.54) suggest that they are not completely distinct in measuring these dimensions of culture. Since, these five dimension of

culture are highly correlated we sort them out into their unique distinct aspects using principle component analysis, PCA. Briefly, this procedure takes a linear combination of these five correlated cultural components and extract uncorrelated factors that takes successive levels of their unique variances. First factor will take the largest proportion of the variance follow by the subsequent factors taking the remaining variance.

As expected, Table 3 shows that the eigenvalue for the first two factors are above 1, therefore, the five Hofstede cultural dimensions can be sort out into two unique and distinct dimensions with the first dimension capture about 45.37% while the second takes 29.79% of the total variance respectively. Both dimensions account for more than 75% of the total variance. Interestingly, Table 4 shows that the first dimension load heavily on PA, UA, and LTO while the second dimension capture on MAS and IND both of which are exactly suggested in the correlation matrix shown in Table 2. PA-UA-LTO (first principle component culture) measures the extend that power is unequally distributed (center in the institutions/organization) in society, and the society tries to avoid uncertainty through formal rules and expertise over the long-time horizon. The IND-MAS (second principle component culture) measures the extend of individualistic and materialistic (self-centered) values. This study argues that through proper accounting for the correlated structure in the measures of Hofstede cultural measures which previous research ignore can provide better insight into how informal institutions (risks) along national culture affect firm performance.

Table 2
Correlation Matrix

	PD	**UA**	**IND**	**MAS**	**LTO**
Power distance (PD)	1				
Uncertainty avoidance (UA)	**-0.6442**	1			
Individualism (IND)	-0.2322	0.3777	1		
Masculinity (MAS)	0.1520	-0.0710	**0.5433**	1	
Long-term orientation (LTO)	0.3433	**-0.5919**	-0.2621	0.1146	1

Table 3
Principle Component Factor Analysis

	2 Hofstede Cultural Dimensions			
	Eigenvalue	**Difference**	**Proportion**	**Cumulative**
Factor 1	**2.26865**	0.77901	**0.4537**	**0.4537**
Factor 2	**1.48964**	0.83204	**0.2979**	**0.7517**
Factor 3	0.65760	0.34302	0.1315	0.8832
Factor 4	0.31457	0.04503	0.0629	0.9461
Factor 5	0.26955	-	0.0539	1.0000

Source: Own calculation. Number of observation = 14071.

Table 4
Factor analysis

	Factor loading after Rotation	
	Factor 1	**Factor 2**
Power distance (PD)	**0.7984**	0.0502
Uncertainty avoidance (UA)	**-0.9048**	0.1012
Individualism (IND)	-0.3734	**0.8372**
Masculinity (MAS)	0.2026	**0.9096**
Long-term orientation (LTO)	**0.7618**	-0.0186

Source: Factors are extracted using Principle Component Analysis method, and rotation is performed using Varimax with Kaiser Normalization. Number of observation = 14071.

As an alternative to culture we also employ new measure of social capital devised by Lee et al. (2011).

Unlike existing data on social capital which centre only on trust and is available mainly for developed countries, this

newly index captures social trust, norms, social network and social structure which are very relevant (beside culture) in capturing the impact of informal institutions on firm performance. In employing this newly developed data the present study contributes to the literature in further augmenting insight on the impact of cross-countries social-capital-based informal institutions on firm performance in emerging markets and developing economies. Social capital is commonly defined as shared norms function to foster cooperation and trust between two or more individuals (Lee et al., 2011). High degree of social capital reflects high corporation and trust society and good "social networks and the norms of reciprocity and trustworthiness" (Putnam, 2000) that function to reduces people's incentive to cheat in their daily activities. These aspects of informal institutions are importance for firm performance. Lee et al. (2011) employing principle component analysis on 44 variables for 72 countries starting from the year 2000, the authors successfully sort out those variables into a unique index capturing a comprehensive multi-dimension measure of social capital that goes beyond social trust to also include norms or attitudes of cooperation, social networks (i.e. membership in two types of voluntary associations, Putnam group: religious organization including education, arts, music, or cultural activity and sport and recreation clubs; and

Olson group: interest group including union, professional association) and social structure (social conflicts and culture).

4. Conclusions

The objective of this paper seeks to examine the differential effects of cultural components (informal institutions) on firm performance in a group of emerging markets. The results are summarized as follows with respect to four Hofstede cultural components.

Results of this study show that, in the emerging markets under preview, uncertainty avoidance (UA), individualism (IND), and masculinity (MAS) exert negative effects on firm performance. Additionally, the results show that long term orientation (LTO) exerts a positive influence on the performance of firm in these countries. The results further reveal that these cultural dimensions complement one another in influencing firm performance. When unique factors are extracted from the five (correlated) cultural components, the study finds that these five components can be uniquely combined into two factors namely PD-UA-LOT and IND-MAS. The empirical results further show that both of these unique cultural factors positively influence firm performance. Thus, this study reveals that the impacts of Hofstede cultural components on firm performance are not straightforward: they have direct individual and collective effects on firm performance. Furthermore, the positive effect from PD-UA-LOT is substantially higher (about sixteen times) that of IND-MAS. This suggests that firms have high performance in PD-UA-LOT cultural environment. This adds important insight into the international business literature that

recently only look at the direct effect of cultural components. This implies that countries embedded with long-term forward looking and planning cultural values tend to promote firm performance (i.e. better profit and productivity). Although the other Hofstede cultural components (i.e. UA, IND and MAS) negatively influence firm productivity, once correlated structure of these cultural components (i.e. multicollinearity) are tackled, as discussed in Chapter 3, their combined influence (i.e. PD-UA-LOT and IND-MAS) on firm performance is positive. This is another important contribution of this study in adding insight to the literature that, as complex as culture (see Leung et al., 2005), each of the Hofstede five simple component measures may not only work straight toward influencing firm productivity but also in two different unique combinations.

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