The Impact of Formal Institutions on Global Strategy in Developed vs. Emerging Economies

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Abstract

This article attempts to investigate the impact of formal institutions in developed and emerging economies on the global strategy of firms. The different institutional environments are influential on the development of a global strategy. Adjustment of the strategy is relevant for the success in international markets. First, the difference in the institutional environment of developed and emerging economies is analyzed. The two markets are compared using three distinct institutions: Business Regulations, Trade Barriers, and Property Rights. To provide a better understanding of the differences, specific information is given on Germany as a developed economy and India as an emerging economy. Second, the impact of the differences on the global strategy of firms is discussed. The results show that countries with weak institutions, as found in emerging economies, require a different global strategy compared to countries with strong institutions, as found in developed economies.

Key Words: Formal Institutions, Global Strategy, Developed, and Emerging Economies

1.0 Introduction

With the advent of globalization and the rapid growth in emerging economies, companies are facing enormous challenges as regards the entry in a particular market. Different entry strategies are used by different companies. What will determine a foreign market entry strategy? Some companies focus too much on their internal resources and capabilities (Anand and Delois, 2002). These are in no doubt important. However, before developing strategies for entry, companies have to take into consideration some other factors, in particular institutions. Formal institutions have a profound impact on the global strategy of businesses. Global strategies are often solely determined on the basis of industry and recourse-based considerations. Institutions though are more than background conditions and are at least as important as the former considerations. Institutions have a direct effect on how well firms are able to formulate and implement their strategies (Peng, Li Sun, Pinkham, Chen, 2009). According to Wright, Filatotchev, Hoskisson & Peng (2005), institutions which are the rules of the game significantly shape firm strategies. Institutions are commonly understood as the "rules of the game in a society" (North, 1990, p. 3).Therefore knowing "the rules of the game" can mean the success or failure of global projects. Peng et al. (2009, p. 64) use the definition of Richard Scott to define institutions as "regulative, normative, and cognitive structures and activities that provide stability and meaning to social behavior." According to Seyoum (2009, p. 166) the World Bank defines institutions "as sets of formal and informal rules governing the actions of individuals and organizations, as well as the interaction of participants in the development process." Tonoyan, Strohmeyer, Habib and Perlitz (2010) also define formal institutions as "those written or formally accepted rules and regulations which have been implemented to make up the economic and legal set-up of a given country" (p. 805). Formal institutions consisting of laws, rules, and regulations are defined as the regulatory pillar that administers individual and firm behavior (Peng, 2009).

Examples of formal institutions include property rights, judiciary system, business regulations, investment laws, etc. Informal institutions, including norms, cultures, and ethics, affect global strategies as well but will not directly be part of this discussion. For the purpose of this article, institutions solely refer to formal institutions. The main function of institutions is to reduce uncertainty. Uncertainty creates transaction costs, which is defined as the cost of doing business (Peng, 2009). The uncertainty of currency risk can lead to great losses with the sudden decrease in currency value. Firms are more likely to pursue business in a country with low uncertainty to reduce their risk of doing business. Institutional frameworks are relevant for the reduction of uncertainty; therefore uncertainty is lower in countries with strong formal institutions compared to countries with underdeveloped institutional structures. As a point of note, informal institutions play a larger role in reducing uncertainties where formal institutions fail.

Institutions vary among countries and have to be carefully considered before entering new markets. Not knowing the "rules of the game" when expanding to a new country can have a devastating effect on a firm. Institutional structures differ especially between emerging and developed economies (Meyer, Estrin, Bhaumik, Peng, 2009). Institutional constraints can be either weak or strong. According to Meyer et al. (2009, p. 63) institutions are strong "if they support the voluntary exchange underpinning an effective market mechanism" and weak "if they fail to ensure effective markets or even undermine markets." Emerging economies are largely considered to have weak formal institutional constraints compared to developed economies with strong institutional structures (Meyer et al. 2009). Since uncertainty is lower in countries with strong institutional structures and firms aim at reducing uncertainties, companies would choose host countries with similar or stronger institutional structures than their home country. Evidence for this statement is given by Yamakawa, Peng, and Deeds (2008) who say that businesses from emerging economies increasingly enter developed economies. Despite the former statement, many companies from developed economies enter markets in emerging economies. Even though risk is higher, many emerging countries offer great opportunities for development. Analyzing the institutional environment and adapting the global strategy is the key for succeeding in countries with different institutional structures. Institutions in emerging economies require more careful consideration, as mistakes can have devastating effects. The discussion will focus on the formal institutional differences between emerging and developed economies and how it affects the global strategy of firms. The institutions subject to discussion are business regulations, trade barriers, and property rights. To give a detailed understanding of the differences, formal institutions in developed economies will be discussed with the example of Germany, and in emerging economies with the example of India. After the essential differences are established, the article will discuss the effect of those differences on the global strategy of firms expanding to international markets.

2.0 Formal Institutions

2.1 Business Regulations

All companies entering a foreign market are subject to the local regulations of establishing a business and can be considered new ventures. Commonly Small and Medium-sized Enterprises (SMEs) that engage in entrepreneurship by forming new businesses through "the identification and exploitation of previously unexplored opportunities" (Peng, 2009, p. 126) are subject to those laws. It is widely recognized that Small and Medium Sized Enterprises (SMEs) form the backbone of the private sector at all levels of developing countries. Greenan, Humphreys, and Mclvor (1997) noted, "The contribution of small and medium sized enterprises towards economic performance is now universally accepted as significant" (p 208). As institutions differ across countries so does the treatment of new ventures. The difference is especially profound between emerging and developed economies (Yamakawa *et al.*, 2008). Each country has individual rules on how to regulate the entry of new businesses. The formation of new firms requires time, money, and start-up procedures. The exact amount differs widely. New ventures have to follow certain start-up procedures in order to establish a new business. The procedures vary across countries, but usually include obtaining permits, licenses, verifications, and notifications to start operations. In general, developed economies are more favorable of new ventures compared to emerging economies (Yamakawa et al., 2008). Data from the World Bank (2011) shows that the number of days it takes to start up a business is commonly greater in emerging economies than it is in developed economies. Djankov, LaPorta, Lopez-De-Silanes, & Shleifer (2002) have indicated that "in Russia, it takes 57 days and 43% of GDP to set up a new business; in India, 77 days and 88%; in China, 92 days and 51%. In construct, in the United States, it takes only 4 days and 1.7% of GDP; in Denmark, 3 days and 11%; and in Australia 2 days and 3% (p. 18-20).

How easy it is to start a new business in a certain country can be determined by the "ease of doing business" index (World Bank, 2011). The World Bank measures each country's business regulations. The evaluation includes the following categories: Starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. Additionally the business environment is determined by the "business freedom" index of the Heritage Foundation (2011).

Developed economies usually have an entrepreneurial friendly environment. The cost of establishing a business is relatively low due to a structured and friendly institutional framework. Yamakawa et al. (2008) argues that new ventures from emerging economies increasingly establish their business in developed economies in favor of the business freedom. Developed economies are likely to have a shorter start up process, reduced procedures, and lower costs. OECD countries on average have the lowest index number compared to other regions such as South Asia and Latin America & Caribbean. In Germany it takes an average of 18 days to set up a new business. The number used to be greater with Germany needing 24 days. It takes 9 procedures in order to form a new business, such as clearing the name of the company and opening a bank account. The cost of establishing a business is 4.8% of income per capita, including official and legal fees, and there is no paid-in minimum capital requirement (World Bank, 2011). The "business freedom" index for Germany is 89.6. The business freedom is well protected and the regulatory framework fosters innovation and business formation (Heritage Foundation, 2011)

The institutional structure in emerging economies is often not entrepreneurial friendly even though countries are working on improving business regulations. Despite the positive development, emerging economies largely are still not supportive of new ventures. SMEs are often discriminated against, because governments prefer to support large domestic firms and occasionally large multinational investors instead of new ventures (Yamakawa et al., 2008). The cost and time to establish a business is high. In India it takes an average of 30 days to set up a new business. This number shows great improvement from the previous 77 days. This evidence shows that countries progress to be more entrepreneurial friendly. A total of 13 procedures are necessary to establish a new business with a cost of 56.5% of income per capita. India has a paid-in minimum capital requirement of 188.8% of income per capita. This amount needs to be proved before business registration (World Bank, 2011). India has a "business freedom" index of only 36.9 as new ventures encounter severe challenges. The problems are a burdensome regulatory framework and a weak legal framework (Heritage Foundation, 2011).

2.2 Trade Barriers

According to Peng (2009) trade barriers are simply defined as "barriers blocking international trade" (p. 161). The country Commercial Guide for U.S. Companies defines trade barriers as "any restrictions imposed on the free flow of trade" (Department of Commerce, 2010, p. 56). Trade barriers can be divided into three different categories: tariff and nontariff barriers, local content requirements, and restrictions on entry modes. Trade Barriers are imposed by governments to protect domestic companies from foreign competition and to collect revenue (Kubota, 2005). The worldwide use of such barriers increases the costs of companies that are doing business internationally. The degree of trade barriers varies among countries. Emerging economies in general have higher trade barriers, especially tariffs, compared to developed economies. Kubota (2005) argues that emerging economies rely more heavily on trade taxes for revenue and therefore impose higher trade barriers. Tariffs, taxes imposed on imports, are a main trade barrier. As multilateral agreements continuously reduce tariffs, many countries turn to other types of trade barriers to protect domestic firms (Marsh, 1998). Such barriers include anti-dumping protection, bureaucratic procedures, licensing requirements, etc. How free the flow of trade in a country is can be measured by the "trade freedom" index calculated by the Heritage Foundation. The higher the index, the more free the flow of trade is (Heritage Foundation, 2011).

Developed economies in general have a trade friendly environment. Germany has an index of 87.6 indicative of a trade friendly environment. Developed economies tend to have a strong institutional framework. Tariffs and other trade restrictions are well controlled and enforced by authorities (Heritage Foundation, 2011). According to Meyer et al. (2009) a strong institutional structure lowers the cost of doing business. Even though developed economies still have trade barriers, the cost is low due to reduced risk. Germany, as a developed economy, has reduced trade barriers. As a member of the European Union (EU), Germany has the same trade policy as other members. The weighted average tariff rate for the EU in 2009 was 1.2% (Heritage Foundation, 2011).

The EU though has especially high tariffs on agricultural and manufacturing products. Non-tariff barriers include agricultural and manufacturing subsidies, quotas, and import restrictions. An example is quotas imposed on textile imports, but which were fully abolished by 2009. Total import bans are very rare and only imposed for public health and environmental reasons. Regulations and bureaucratic procedures can present a trade barrier as the processes are very detailed. Germany has complex safety standards that harden the entry for foreign companies (Department of Commerce, 2010). Anti-dumping protection is enforced by many developed economies to protect domestic firms against foreign competition. EU anti-dumping regulations allow protectoral measure against foreign companies that sell products below their cost of production, if the imports cause harm to EU industries (Department of Commerce, 2010).

Emerging economies often have a restrictive trade environment. India's trade freedom index for example is 64.2 compared to the average of 74.8 (Heritage Foundation, 2011). Emerging economies impose higher trade barriers in the belief to protect domestic firms. Governments often apply higher tariff rates due to the need of revenue. Import taxes are easy to collect and present an important source of income for many low income countries. Statistics show that lower income countries have higher percentage of trade tax in government revenue compared to higher income countries (Kubota, 2005). India had a weighted average tariff rate of 7.9% in 2009 (Heritage Foundation, 2011). The current tariff rate already presents a drastic decrease from previous years. Tariffs on agricultural products are still high compared to international standards. India imposes several types of custom duty on all imports to protect local industries from injury. India uses anti-dumping protection heavily to create entry barriers for foreign firms. In 2006 India initiated 20 new anti-dumping investigations, seven times more than the U.S. No other country initiated as many anti-dumping cases. The procedures have often been nontransparent and questionable. The Indian government imposes equity restrictions and other trade-related investment measures. Foreign Direct Investment (FDI) is limited in certain sectors, such a retail trade and agriculture. No FDI is permitted in farming and foreigners are not allowed to own farmland. In retailing only 51% FDI is allowed in single brand products. Broadcasting is subject to 20% FDI. Those measures discriminated foreigners and give an unfair advantage to local companies. India pursues unofficial policies that favor counter trade (Department of Commerce, 2010). The weak institutional framework imposes an entry barrier against acquisitions. Acquisitions require a strong institutional framework and efficient markets (Meyer et al., 2009). The absence of these factors imposes an automatic entry barrier.

2.3 Property Rights

The protection of property rights is an important aspect of formal institutions. Property rights protect the accumulated private property of individuals and firms. Mokyr (1990) has indicated that private property must be protected as a requirement for sustained economic growth. Property rights include enforcement of contracts, intellectual property, and ownership. Seyoum (2009) argues that countries with a strong formal institutional framework have well protected property rights. Countries with weak formal institutions in contrast often lack secure property rights. The enforcement of property rights is critical for businesses in order to operate with minimal risk. The protection of intellectual property is of special importance. Intellectual Property includes copyrights, patents, trademarks, and designs. The degree of property rights enforcement varies greatly among countries. While some countries only have limited property rights, other countries merely lack enforcement of existing rights. The Heritage Foundation measures the degree of property right protection in each country with the "property rights" index. Private property is more secure with an increasing index number. A lack of property right protection can lead to corruption and expropriation. Business risk is increasing with a decreasing enforcement of property rights (Heritage Foundation, 2011).

As developed economies in general have strong formal institutional structures property rights are well protected. The government guarantees the strict enforcement of those rights. The court system is efficiently enforcing contracts and punishing unlawful doings. Globerman and Shapiro (2003) show that countries with a more impartial and transparent legal system and better protection of property tights tend to attract more U.S. FDI. Corruption is not existing or very limited. Expropriation by the government is very unlikely, even though most countries have expropriation laws. The law is barely applied and only for the well-being of the countries. Germany has a "property right" index of 90 indicative of secure property rights (Heritage Foundation, 2011). The German law protects property owned by both locals and foreigners. There are almost no restrictions for foreigners to own or control property or equity interests.

Intellectual property is very well protected with Germany being a member of the World Intellectual Property Organization and major international intellectual property protection agreements. Patent applications are subject to the 'first to file' approach making early filing a priority for companies (Department of Commerce, 2010).

Property rights in emerging economies are often not well protected. The lack of strong formal institutional structures makes the enforcement of property rights difficult (Seyoum, 2009). Some countries might only have limited laws to protect property, but others just lack the enforcement of the existing laws. The judicial system is often influenced by other branches of the government, making independent decisions difficult. With weak formal institutions corruption is often possible. Expropriation is also more likely in emerging economies (Heritage Foundation, 2011). India for example required for Coca-Cola to share their secret formula when trying to enter the country in the 1970s (Peng, 2009). India has a "property right" index of 50 indicative of unsecure property rights due to an inefficient court system (Heritage Foundation, 2011). Indian courts often take years to reach decisions. The transfer of land is restricted under the legal system. Titles are often unclear leading to problems during the buying and selling process. The protection of intellectual property is limited. Even though India has adequate copyright laws they often lack enforcement. Piracy of copyright material is common. The Indian government does not protect proprietary test results submitted to the government for marketing approval by pharmaceutical companies. Domestic companies often use those results without legal penalties as the Indian law does not provide protection against unfair commercial use. India is not a member of the World Intellectual Property Organization (Department of Commerce, 2010).

3.0 Global Strategy for Developed vs. Emerging Economies

The formal institutional differences between developed and emerging economies have a critical impact on the global strategy of businesses. Entering developed economies calls for a different global strategy than entering emerging economies. New ventures for example, are treated differently in developed companies than in emerging economies. Start-up businesses are more likely to internationalize in countries with an institutional friendly structure supportive of new ventures (Yamakawa et al., 2008). Initial internationalization is therefore likely to take place in developed economies. It is easier to start a new business in a developed economy due to a shorter start-up process and fewer procedures. Entering an emerging economy is more costly and requires more paid-in minimum capital. Many new ventures are discriminated by the government of emerging economies. It is easier for Multinational Enterprises (MNE) to enter emerging economies than it is for SMEs as MNEs might receive support from the local government. MNEs also have more financial resources to meet the requirements of official and legal fees as well as paid-in minimum capital. For SMEs it is often easier to enter developed economies as they face reduced costs, a shorter start-up process, and lower paid-in minimum capital requirements.

SMEs do not have the same resources as MNEs. Research from Yamakawa et al. (2008) reveals that start-up businesses from emerging economies are increasingly entering developed economies due to the friendly institutional environment. Examples include the listing of Israeli new ventures in New York and Russian new ventures on the London stock exchange (Yamakawa et al., 2008). Rigorous start-up procedures discourage market entry though Greenfield operations or acquisition and rather call for exporting or Joint Ventures (JVs) as a market entry strategy for emerging economies. With an entrepreneurial friendly environment, wholly-owned subsidiaries might be easy to establish, but in emerging economies the procedure can easily become burdensome. While exporting might still hold costs too due to tariffs, it might be less costly in regards to fees and procedures. JVs hold the advantage of accessing the partner's knowledge of domestic practices and procedures.

Entry barriers in host countries determine a company's strategy to enter the market. Entry barriers in emerging economies are often greater than in developed economies. The trade environment in developed economies is considerable free and favorable of foreign entry and investment compared to the constrained trade environment in emerging economies. Emerging economies frequently impose limits on foreign direct investment for certain industries. Restrictions by the FDI have a direct impact on entry choices. FDI restrictions eliminate market entry through Greenfield operations and acquisitions. Companies can enter FDI restricted industries only through JVs or non-equity modes, such as exporting or contractual agreements. Developed economies have very limited FDI restrictions and mainly only in public sectors. Developed economies can therefore be entered through all forms of FDI. Acquisition as an entry mode is mainly limited to developed economies (Meyer et al., 2009).

Countries with strong institutional structures can be more easily entered through acquisition as this entry mode is especially sensitive to market efficiencies. Acquisitions are often controlled by the host governments and require strong institutions to enforce contracts and provide transparent financial data. After acquisition of a significant part of equity, companies can be obtained with friendly or hostile measures. Emerging economies have smaller and less liquid stock markets due to weaker institutions and companies are therefore controlled by a dominate stakeholder. If institutional structures in an emerging country increase, acquisition becomes more likely (Meyer et al., 2009). Exporting is subject to tariff rates. As established earlier, tariffs in emerging economies are generally higher than in developed economies. Exporting is a good option for initial internationalization since it requires minimal investment. Especially emerging economies, despite the higher tariff rates, should be at first entered through exporting as it bears limited risk and helps companies to assess the institutional environment.

Protection of property rights is an indicator for a country's institutional framework. Property rights are better protected in countries with strong institutions compared to countries with weak institutional structures. Weak institutional structures create an uncertain investment environment and increase the risk of doing business. Companies therefore rather invest in developed economies than in emerging economies since the FDI carries high sunk costs and the institutional environment in emerging economies is too uncertain. Companies can still enter emerging economies through the FDI without taking too much risk by establishing joint ventures. In an institutional weak environment JVs are safer than wholly-owned subsidiaries (Seyoum, 2009). A study by Meyer et al. (2009) show that JVs provide the necessary resources, such as networks, to overcome weak institutional structures. JVs give access to the knowledge of partners and split the risks and costs (Peng, 2009). JVs in developed economies carry the risk of knowledge transfer and wholly-owned subsidiaries are safer due to property rights protection. In emerging economies though the risk is equal, as poor property rights not even protect knowledge and intellectual property in wholly-owned subsidiaries. The protection of intellectual property is especially important for certain industries. Companies entering a foreign market need to assess the host countries protection of intellectual property and their products vulnerability to theft and copying. A plan needs to be established how to best protect the intellectual property before entering a foreign country.

In developed economies several options are available, such as copyright, trademarks, and patents. Procedures vary and need to be carefully considered. More alertness is required regarding property rights protection in emerging economies. With emerging economies generally having poor property right protection or enforcement, different strategies need to be determined. Microsoft for example could not stop piracy of its software in India and therefore cooperated with the government and eventually allowed piracy. Weak institutional structures, such as in form of poor property rights, often require cooperation with the local government. According to Diaconu (2008) governments in emerging economies are more influential than in developed economies. Governments are likely to help Multinational Enterprises to enter the host country through foreign direct investment if they do not fear that the domestic industry will be threaded through the entry of foreign companies. It is especially important in emerging economies to build good relationship with the local government (Diaconu, 2008). Microsoft was able to overcome its piracy problems in India through cooperation with the government and the establishment of a new approach.

4.0 Results

The discussion of three important formal institutions in developed and emerging economies reveals a profound difference in the institutional structure of those two economies. Developed economies tend to have stronger institutions compared to emerging economies with weaker institutional structures. Three findings support this statement. (1) Developed economies tend to have more business friendly regulations, while emerging economies make the market entry for new ventures more difficult. (2) Developed countries have reduced trade barriers and largely promote free trade. Emerging economies in contrast often have high trade barriers and restrict imports and foreign investments. (3) Property rights in developed economies are protected well, while emerging economies lack property rights protection and enforcement. While these findings are not necessarily true in all cases, they can be found in the majority of developed and emerging economies.

Since formal institutions are important for the reduction of uncertainty, companies aiming to internationalize need to carefully analyze the underlying institutional structure of the intended country of entry. The goal for companies is to reduce uncertainty and therefore reduce the cost of doing business. To cope with the different institutional structures, businesses need to adapt their global strategy in order to successfully compete in foreign countries.

There are basic differences in the global strategy for developed economies compared to the strategy for emerging economies, even though each global strategy requires slight adjustments due to the varying institutional frameworks in host countries. Businesses entering an emerging economy need to have a different global strategy to cope with the weaker institutional structures compared to businesses entering developed economies. While this is beyond the scope of this discussion, just as a point on note, a company's global strategy is also affected by the institutional structure in the home country. A company from an emerging economy entering another emerging economy with similar institutional frameworks experiences less uncertainty compared to a company from a developed economy entering an emerging economy.

5.0 Conclusion and recommendations for future research

The paper has clearly established that there are fundamental differences in the formal institutional environment of developed and emerging economies. While the results are clearly not applicable to all countries, they outline common differences found in many developed and emerging economy. Each country is unique and the individual institutional structures need to be carefully analyzed before entering a new market. Rules, laws, and regulations play an important role when entering a foreign country. Formal institutions have a direct impact on the global strategy of businesses expanding to international markets. The weak institutional framework in emerging economies calls for exporting and joint ventures as a market entry strategy instead of wholly-owned subsidiaries. If formal institutions increase, market entry through wholly-owned subsidiaries becomes more likely. Developed economies with strong institutional structures can therefore be entered more easily through Greenfield operations and acquisitions. Formal institutions present only part of a country's institutional environment. Informal institutions play an important role as well and require attention beyond the scope of this paper. Evidence shows that informal institutions play a larger role in countries with weak formal institutions. Companies should therefore pay attention to informal institutions especially when expanding to emerging economies. Future research should expand on this paper and also examine how informal institutions will impact on global strategy of firms.

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