SRIVIDYA JANDHYALA
MANAGEMENT DEPARTMENT
srividya@wharton.upenn.edu

De Jure & De Facto Protection and Impact on MNC Location Choices
Research Grant Proposal to the Russell Ackoff Doctoral Student Fellowships

Advisor: Prof Witold Henisz
Doctoral Coordinator: Prof Lori Rosenkopf

Multinational corporations (MNCs) are increasingly pursuing opportunities in factor, product and service markets abroad, especially in developing country markets. Their performance in these markets is strongly influenced by their ability to identify the risks and opportunities in the institutional environment and influence political, legal, regulatory or other policy outcomes. A recent global survey by the Economist Intelligence Unit (2005) found, for instance, that the problems arising from new or existing regulations constituted one of the greatest threats to businesses, especially in international investments.

On the other hand, national governments across the world are increasingly adopting liberal economic ideas and policies, joining international regimes that govern them and creating new domestic institutions to allay precisely such risks for investors. For instance, the over 160 countries have signed the Berne Convention and thus pledge to protect literary and artistic works. The adoption of a copyright law to protect computer programs is also almost universal. If these reforms were completely credible and effective, multinational investors would benefit from harmonized legal regulations, similar standards across the countries of their operations and high standards of protection. However, any reform or policy adopted by the government to protect the MNC investor is not always credible, giving rise to uncertainty. The classical bargaining power literature (Vernon, 1977) has identified the time inconsistency problem associated with MNC-Host country interactions. When the initial advantages of MNCs erode, bargaining power shifts to the host country governments who may then renegotiate the initial agreement in their favor.

There is a second inconsistency problem that has received relatively less attention in the literature. This is the inconsistency that arises due to the ceremonial adoption of reforms by host country governments. While the de jure regulations may exist, the de facto protection that MNC investors are provided in the host countries may be vastly different. For the formal regulations to have an impact on MNC strategy, they have to be credibly enforced (Pistor, Raiser & Gelfer, 2000) and implemented. Under poor *de facto* protection, firms face policy uncertainty, issues of credibility of their commitments and increased cost of doing business. Hence, for MNC firms making decisions on location choices, both *de jure* and *de facto* protection are important. In addition, firm heterogeneity plays an important role in mitigating some of this uncertainty. I argue that large multinational firms (more than small firms) are more capable of learning from their external environments and creating effective substitutes for weak institutional environments by utilizing their internal firm capabilities and arbitraging international location differences. Hence, such firms are better at dealing with the institutional uncertainty and are impacted to a smaller degree by the effects of de jure and de facto protection.

To understand the risks and uncertainty faced by firms in their investment decisions, I would like to build a data set on foreign investments by firms in the information services sector from 2002 to 2005. This includes firm and country level data. Specifically, I identify national laws and international treaties that provide *de jure* protection and government effectiveness, domestic interests and international ratings to measure *de facto* protection. I also observe firm level data on investments and firm characteristics such as extent of international operations, size and R&D expenditure.

This study aims to inform the literature on managerial decision making under conditions of environmental uncertainty arising from the host country institutions. Most of the prior studies that have looked at the role of institutions on MNC strategy have focused on the formal regulations. For instance, MNC's strategic choices such as location, entry mode characteristics and corporate finance decisions have been studied as a function of the host country's policy making structure (Delios & Henisz, 2003; Henisz & Macher, 2004), legal regulations governing FDI (Chung & Beamish, 2005) and tax (Altshuler & Grubert, 2003), legal systems (La Porta et al, 1998) and strength of Intellectual Property laws (Oxley, 1999). However, I would like to consider both the *de jure* and *de facto* protection provided by the state.