

## The Impact of Formal Institutional Risks on Firm Performance in Emerging Market Economies

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### Abstract

The aim of this study is to empirically reconcile the impact of formal aspects of host countries' institutional risks on the performance of multinational firms in emerging economies. In addition, this research seeks to provide a comparative study on formal institutions focusing on both aggregate and selected disaggregate core aspects of formal institutions is relied upon to assess their impacts on firm performance in emerging economies. In this study, the measures of qualities of formal institutions are collected from World Bank's Enterprise Survey (WBES). Through consistence empirical examinations, the research has met its objective in analyzing formal institutional risks as well as it's interaction effect on the performance of firms in emerging market economies.

Keywords: Host's institutional environment, Firm performance, Formal institutional risks, Emerging market economies

### 1. Introduction

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). This study specifically extends and fill the gaps in its focus that include crucial formal institutional dimensions, such as corruption, competencies of bureaucracy, stabilities of the government (i.e. political risks), property rights protection and enforcement, and regulations on the business activities, credits and labor, as well as the overall institutional environment that are critical for foreign firms and assess its impacts on firm performance (e.g. degree of profitability).

### 2. Research Hypothesis and Framework

Based on evidences in the literature, the relationship between institutions and firm's performance is hypothesized as follow:

Since high qualities or low risks of formal institutions represent low transaction cost environment, firms operating in such context are likely to perform better than those operating in the weak (high risks) formal institutional environment. This is because firms incur lower transaction cost as security and protection of property

rights are better ensured. The profitability and long-term prospects of the investments would be impaired in high risk formal institutional setting or context since firms cannot reap the benefits/profit from its investments due to high transformational and transaction costs (e.g. expropriation of the private business profit, corruption, incompetent and cumbersome bureaucracies, excessive regulations on business activities). The recent case in point was shown by Sufian and Habibullah (2010), and Wu (2013), that institutional development (i.e. legislative institutions and economic freedom) increases the performance of firms in emerging economies. We would expect:

**H1:** Better formal institutional environment (i.e. lower formal institutional risks) positively influences the performance of the domestic and foreign firms.

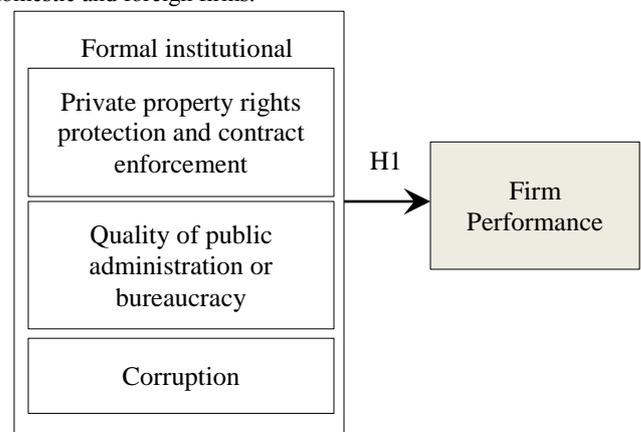


Fig. 1. Study Framework