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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.

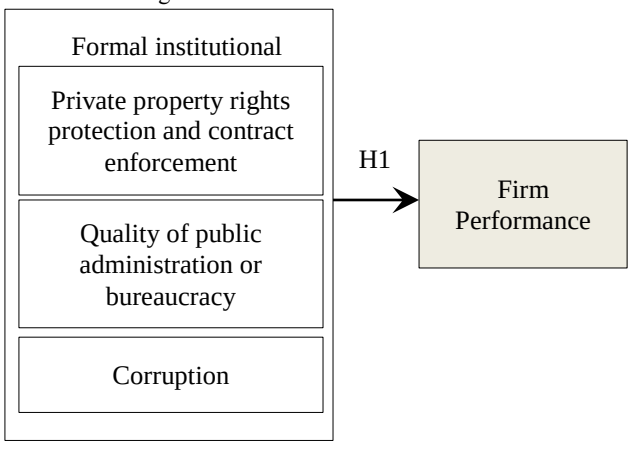

Fig. 1. Study Framework

3. Literature Review

Institutions are well-known to have broad meaning. However, the well accepted definition and framework is that of Nobel Laureate Douglas North (1981, 1990). He devised an institutional framework that take into account both formal and inform aspects of institutional infrastructure. Though North's (1981, 1990) institutional framework emphasize on broad institutions; the formal institutions aspects entered on two important sets of formal institution namely "contracting institutions" and "property rights institutions" reflecting the dilemma of the state's function. According to Acemoglu and Johnson (2005), these core formal institutions reflect in North's (1981, p. 20-27) "contract theory" and "predatory theory" of the state, respectively. North's (1981) contracting theory of the state concerns legal frameworks that are provided by the state and its various institutions to facilitate and support private contracts so to reduce transaction cost in the economic transactions and exchanges (Acemoglu and Johnson, 2005). Thus, better quality of this set of institutions ensuring private contracts, from both sides of the contract, are well observed and enforced would support well-functioning market. Weak institutions enforcing contracts would encourage opportunistic behaviors among the contractual parties, hence high transaction cost, as each side engages in extra cost to ensure the contract is observed, e.g. hire guards, monitoring agencies. In contrary, North's (1981) predatory theory of state stressed on the facts that state also functions as tool by those controlling it to transfer the resources from one particular base to another (Acemoglu and Johnson, 2005). This predatory view on the role of state reflects property right institutions. Weak set of these institutions reflect low/unconstraint powerful elites and politicians which tend to redistribute the resources to them or their group. This may works from a high tax, corruption and rent seeking activities to outright expropriation of private property such as nationalization without compensation, stealing and theft.

Some scholars for instance found that they are important determinant of firm venturing and partnership with local partners in that environment (Meschi and Riccio, 2008) and the formal aspects of institutions when they are non-existence or weak quality. For instance in weak formal institutions (low institutional constraints to ensure elites and powerful groups or individual do not expropriates others' private property and that contract is not well enforced), then trust among business partners and business culture in a particular countries and language similarities may also play important role in the success and failure of business venture and performance. Particularly, culture were shown to determine work managers' leadership style (Byrne and Bradley, 2007), performance of firms' strategic-alliance (Li et al., 2012), quality of bank earning (Kanagaretnam, Lim, and Lobo, 2011), and firm's work orientation (Gomez-Mejia, 1984), among others. Kirkman et al. (2006) and Venaik and Brewer (2010) provide a good survey on the issue of culture and its influence on international business.

Despite the important of private property rights and contracting institutions, international business literature mainly focus on one aspect of institutions namely political risks. Beside political risk, recent studies also 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). In what follows, empirical studies on the effects of formal on firm entry mode and performance are reviewed.

Institutions formal dimensions are the underlying factors that determines socio-political and economic fabrics of a country. The important role of institutions in explaining the failure and success of business has recently been receiving great attention among international business studies (Henisz and Swaminathan, 2008; and the special issue on institutions in Journal of International Business Studies (JIBS); Griffith, Cavusgil, and Xu, 2008).

At the macro- or country-level, it has been a well-accepted view that institutions directly explain why some countries are poor while others are rich. However, evidence at micro-level, how formal institutions matter in supporting markets in providing conducive environment for entry and exit of firms and entrepreneurs and more importantly the performance of firms in that environment are far lag behind. Although above recent studies in the international business literature suggest that formal institutions matter for firm entry but less evidence on firm performance. Further, these existing evidence mainly centered on one aspect of host countries' formal institutional risk namely political risks and a commonly focus on culture. Furthermore, such evidences are either based on developed countries or a mixed sample between developed and developing countries, an exclusive focus on emerging economies has so far been limited. Moreover, only few recent studies have looked at interaction effects between formal institutions but focus on firm entry (López-Duarte and Vidal-Suárez, 2010; Jiménez, 2010). To fill these gap on institutions and firm performance, this research seeks to provide a study on formal institutions focusing on core aspects of formal institutions is relied upon to assess their impacts on firm performance in emerging economies.

4. Methodology and 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

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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. The list of countries and total number of firms is presented in Table 1.

In measuring the quality of embeded underlying institutions in a country, scholars rely on opinion based subjective measures. Accordingly in this study, the measures of qualities of formal and informal institutions are collected from sources mentioned above. Measures of the quality of formal institutions are from both firm-level and country-level data, while that of informal institutions are only available at the country level. Firm level data means that each firm has a particular value on each variable, while country level data means each country has one particular value for each variable. In what follows throughout this study, for variables that are only available at country level, all firms for that country take only one (and the same) value. Thus, the variation in the data comes from both countries and firms (i.e. cross-country and -firm variations).These institutional measures usually come in the form of scores along a particular scale, for example 0 to 10, or 0 to 100. These scores reflect opinions of the business community through surveys, and the experts on the extentof quality of the institutions.

Table 1
List of countries and total number of firms

Country	Number of Firms	Year	Country	Number of Firms	Year
Bangladesh	1001	2002	Slovenia	223	2005
Brazil	1642	2003	Poland	975	2005
China	2400	2003	Ukraine	594	2005
Indonesia	713	2003	Hungary	610	2005
Pakistan	965	2002	Czech Republic	343	2005
Philippines	716	2003	Romania	600	2005
Sri Lanka	452	2004	Bulgaria	300	2005
South Africa	603	2003	Latvia	205	2005
Egypt	977	2004	Lithuania	205	2005
Senegal	262	2003	Estonia	219	2005
Morocco	850	2004	Russia	601	2005
Malaysia	902	2002	Turkey	1323	2005
Thailand	1385	2004	South Korea	598	2005
Vietnam	1150	2005	India	2286	2006
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			

Take, for instance, quality of legal institutions. WBES measures the quality of legal institutions through the survey questions on managers: Whether they are confident that the judicial system will enforce their contractual and property rights in business disputes. The level of confidence is measured in six increasing categories (1. Fully disagree; 2. Disagree in most cases; 3. Tend to disagree; 4. Tend to agree; 5. Agree in most cases; 6. Fully agree). This rating will reflect the quality of the legal institutions that ensure the protection of property rights and enforcing contracts. Thus, it is clear that bigger value of this index reflects better quality of legal institutions.

The case for countrywide level of corruption (and the rest of institutional measures) is similar. ICRG views corruption as a reflection of institutional structure that allows people to assume position through patronage rather than ability. The most common form of corruption met directly by businesses is financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans. More seriously, corruption in the form of excessive patronage, nepotism, job reservations, 'favor-for-favor', secret party funding, and suspiciously close ties between politics and business. ICRG' staffs collect, analyze and asses this information and convert it into the score that reflects the degree of corruption that exists in the countries. Low corruption means high quality institution or low institutional risks, ensuring meritocracy system allowing people to assume position based on their ability and talent. Similarly the case of the rest of institutional indicators is that higher score reflects high quality institutions. The quality of formal institutions is measured both at firm and country levels. The overall institutions come from both ICRG and EF, and are country level measures. As mentioned in the preceding section, ICRG aggregate measure of overall quality of

An International Journal JSCDSS
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institutions of a country is the sum of 12 sub-components namely government stability, socioeconomic condition, investment profile, internal and external conflicts, corruption, military in politics, religion in politics, law and order, ethnic tensions, democratic accountability, and bureaucratic quality. This index ranges from 0 to 100, with the larger number indicating better quality. This index is standard in political economy literature (Knack and Keefer, 1993; Acemoglu et al., 2001, Hall and Jones, 1999). EF reflects the quality of institutions ensuring the freedom of economic exchange. The EF measure is also an aggregate measure taken from Heritage Foundation and Wall Street Journal. It is the sum of 10 components namely business freedom, trade freedom, monetary freedom, government size/spending, fiscal freedom, property rights, investment freedom, financial freedom, freedom from corruption, and labour freedom. This index ranges from 0 to 100, with the larger number indicating better quality. This index has been referred to in studies on firm performance (see for example Yaser et al., 2011). Both are referred in this study because they are the most commonly used index of the quality of institutions in the literature.

In an attempt to probe deeper into specific institutional dimension that matters more directly to firm performance, this study looks specifically on a handful of institutions. First, the degree of private property rights protection and contract enforcement. This institutional dimension is crucial to the functioning of market economy, and therefore firm performance, as emphasized by North's institutional framework and empirical evidence (Acemoglu and Johnson, 2005; Yaser et al., 2011; Sufian and Habibullah, 2010). The quality of this institution is measured through the degree of legal system enforcing contractual and property rights in business disputes (LEGAL). This index is derived from a survey question in WBES that asks managers of the firms whether they are confident that the judicial system will enforce their contractual and property rights in business disputes. The level of confidence is measured in six increasing categories (i.e. 1 to 6 scale), which is rescaled to 10 to 60 to make it more comparable with the rest of other measure of institutions, with the larger number meaning higher quality. In addition, as robust checks, the corresponding country level index of property rights from Heritage Foundation and Wall Street Journal and ICRG's index of rule of law and order are also employed.

Another dimension is corruption. As indicated in the preceding section, it is significant to firm performance, as corruption is a cost to business. Corruption is a threat to business because it distorts economic and financial environment and reduces efficiency of government and business operations. It makes it difficult to conduct business effectively, and in some cases may force the withdrawal or withholding of an investment, lead to popular discontent, unrealistic and inefficient controls on the state economy, and encourage the development of the black market. Countries possessing the underlying institutions that ensure that the environment is free from corruption would ensure healthy business environment, i.e. low cost environment.

Empirical evidence have shown that corruption negatively affects a firm's performance, reduces foreign firm operating efficiency, and shrinks profitability to the extent that firm owners or managers may have underestimated the burden of corruption on their business (Habib and Zurawicki, 2002; Yaser et al., 2011; Sufian and Habibullah, 2010; Clark, 2011). The firm-level index on the extent of bribery (Bribe) that a firm has to incur is employed to measure corruption. This study follows Yaser et al. (2011) in measuring firm-level corruption using bribery variable from WBES. The survey asked managers: "We have heard that establishments are sometimes required to make gifts or informal payments to public officials to 'get things done' with regards to customs, taxes, licenses, regulations, services, etc. On average, what percent of annual sales value would such expenses typically cost a firm like yours?"

As a robust check, ICRG's country-level corruption index and freedom from corruption index from Heritage Foundation and Wall Street Journal are also employed. As another robust check, we also employ a firm level measure of the level of corruption that firms consider in their day-today experiences as an obstacle to their business performance or operation. Firms were asked to consider which elements represent the biggest obstacle (business constraint) they face. The elements includes access to finance and land, licensing and operating permits, corruption, courts, crime, theft and disorder, custom and trade regulations, tax, electricity, telecommunication, inadequately educated workforce, macroeconomic instability (inflation, exchange rate), economic and regulatory uncertainty, informal practices (anti-competitions). We select corruption variable (CORUPT) which is measured in five categories (1 very severe obstacle; 2 major obstacle; 3 moderate obstacle; 4 minor obstacle; 5 no obstacle). This study also makes an attempt to provide comparative evidence on the effects of formal institutional risks along the firm level business constraints. We do so by sorting out these correlated dimensions of the above elements of business constraints into unique factors using principle component analysis (PCA).

The last specific dimension of formal institutions that this study focuses on is quality of public administration or bureaucracy (BQ). It is the institutional strength and quality of the bureaucracy that governs without drastic changes in policy or interruptions in government services, somewhat autonomous from political pressure, and has an established mechanism for recruitment and training. High quality in this institutional dimension acts as shock absorber in minimizing revisions of policy when governments change. Any abrupt or drastic changes in policy create uncertainty to the business environment that negatively affect a firm's performance. This study uses ICRG's country-level bureaucratic quality index. In countries where the bureaucracy has such institutional strength and expertise ICRG will award high score points. A country that lacks the cushioning effect of a strong bureaucracy receives low

An International Journal JSCDSS
E-ISSN: 2289-8603

points because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions. As robust checks, ICRG's index on stability of the government (GOVSTAB) is also employed. GOVSTAB reflects an assessment of both of the government's ability to carry out its declared programs, and its ability to stay in office.

5. Main Results and Discussion

Table 2 reports the empirical results with respect to the direct effects of aggregate formal institutions on firm performance. First, it can be noted from the table that about 45% of the variation in the firm performance (Model 1.1) as measured by labor productivity are explained by the included variables. In addition, the joint significant F-test on all variables is in favor of the alternative hypothesis that all the variables included are jointly important in explaining the firm performance. In addition, it can be observed that most of the core variables are highly significant at 1% level.

Specifically, as expected, firms that export intensively using their resources (e.g. fixed inputs), import needed technology and other intermediate inputs, and spend more on innovative related activities such as research and development tend to enhance their performance. These findings are in line with recent studies on firm performance (Yaser et al., 2011; Wu, 2013; Nguyen et al., 2012). It should also be noted that these results are quite robust to the alternative models (Model 1.2, and Model 1.3) using alternative measures of aggregate formal institutions. However, the share of foreign ownership (i.e. more than 10%) and skilled labor do not have significant effects on firm performance. This in fact reflects the mix macroeconomic evidence on the role foreign direct investment plays in the economic performance of the host countries (see for example Gorg and Greenaway, 2004; Herzer et al., 2008). Furthermore, the firm age (duration since it was established) has a significant and negative effect on firm performance. When the square term of the age of firm was added into the model, it has positive sign and highly significant at the 1% level. This is why recent study like Yaser et al. (2011) for example also includes the square term of this variable in their model. Thus our result partially confirms that being young in the business may be a disadvantage for firms but once they age sufficiently (i.e. more experience and strategic insights and other related enhancing factors) their productivity improves.

It can be noted that the sign and significance of controlled variables are generally in line with the ones reported in Tables 2 and 3 interestingly, the results on these specific dimensions of formal institutional matrix are in line with our hypothesis that lowering formal institutional risks (increase in formal institutional qualities) improves firm performance. First, Model 2.1 shows the coefficient on legal property right protection is positive and significant at 1% level. This suggests that countries with perceived better good quality of legal institutions that protect private property rights and enforce contract (high degree of confidence among firm operating in the countries that judicial system will enforce their contractual and property rights in business disputes) promote better firm performance. Second, Model 2.2 shows that the coefficient on bribe variable is negative and significant at 5% level. This means that the higher the fraction of firm revenue are required to bribe the corrupt public officials to get thing done (e.g. matters related to customs, taxes, licenses, regulation,…), the lower the firm performance (i.e. the less the productive firms would become). This result confirms recent evidence in the literature (e.g. Yasar et al., 2011). In general, aggregate institutional risks have a nonlinear effect on firm performance while legal institutions, corruption (i.e. economic institutions) and political institutions (stability of government institutions) have enhancing effects on firm productivity in the emerging market economies. These results clearly indicate that level of overall institutional risk should be low enough (i.e. below the threshold) before it can translate into improvement in firm performance, while lowering specific dimensions of institution risks that matter most directly to firm productivities improve firm performance even when those specific risks are at the time high. In the following sub-Section we check the robustness of these main findings along a number of strategies.

An International Journal JSCDSS
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Table 2
Nonlinearity of formal institution risks and firm performance in emerging market economies

	Dependent Variable: Log of Labour Productivity		
	Model (1.1)	Model (1.2)	Model (1.3)
Age of the firm	–0.0147 (0.0012)***	–0.0027 (0.0011)**	–0.0073 (0.0012)***
Exporting dummy	0.1076 (0.0554)*	0.1751 (0.0507)***	0.2387 (0.0549)***
Foreign direct investment dummy	0.0327 (0.0837)	0.2765 (0.0786)***	– 0.0384 (0.0890)
Import share	0.0077 (0.0008)***	0.0070 (0.0007)***	0.0036 (0.0008)***
Capacity utilization	0.0020 (0.0010)**	0.0073 (0.0009)***	0.0049 (0.0010)***
Skilled labor share	0.0004 (0.0009)	0.0004 (0.0007)	0.0005 (0.0010)
Natural log of 1 + R&D	0.0399 (0.0117)***	0.0281 (0.0099)***	0.0549 (0.0112)***
Inflation	–0.2465 (00064)***	–0.3469 (0.0072)***	–0.2927 (0.0096)***
Formal institutional risk			
International country risk guide (ICRG)	–0.8681 (0.0705)***		
$ICRG^2$	0.0036 (0.0005)***		
Economic freedom index (EF)		–3.6561 (0.0629)***	
EF^2		0.0285 (0.0005)***	
World Bank World Governance Indicator (WGI)			–4.0771 (0.0908)***
WGI^2			2.5142 (0.1259)***
R^2	45.39%	53.56%	42.85%
F-statistics (*p*-value)	0.0000	0.0000	0.0000
Observation	13509	13509	13509

Note: Robust standard errors are in parenthesis. Each multiple OLS regressions includes constant and controls for dummy variables that capture firm size, year and industry characteristics. ***, ** and * indicate significance level at 1%, 5% and 10% respectively.

Table 3
Components of formal institutions risks and firm performance in emerging market economies

	Dependent Variable: Log of Labour Productivity		
	Model (2.1)	Model (2.2)	Model (2.3)
Age of the firm	–0.0159*** (0.0014)	–0.0164*** (0.0016)	–0.0093*** (0.0013)
Exporting dummy	0.2100*** (0.0695)	0.0274 (0.0774)	0.0391 (0.0634)
Foreign direct investment dummy	0.0508*** (0.1095)	0.0448 (0.1132)	0.2365** (0.0981)
Import share	0.0109*** (0.0011)	0.0067*** (0.0011)	0.0012 (0.0009)
Capacity utilization	0.0022* (0.0013)	-0.0002 (0.0013)	0.0050*** (0.0011)
Skilled labor share	0.0015 (0.0010)	0.0013** (0.0006)	0.0017*** (0.0003)
Natural log of 1 + R&D	–0.0011 (0.0149)	0.0238 (0.0183)	0.0382*** (0.0128)
Inflation	–0.1454*** (0.0069)	–0.1100*** (0.0066)	–0.2642*** (0.0079)
Formal institutional risks			
Legal dimension			
WBES Legal property rights protection (Legal)	**0.0178*** (0.0016)**		
Economic dimension			
WBES Bribe		**–0.0061** (0.0027)**	
Political dimension			
ICRG Government Stability (GOVSTAB)			**0.7197*** (0.0252)**
R^2	26.54%	25.53%	25.68%
F-statistics (*p*-value)	0.0000	0.0000	0.0000
Observation	11877	9289	13509

Note: Robust standard errors are in parenthesis. Each multiple OLS regressions includes constant and controls for dummy variables that capture firm size, year and industry characteristics. ***, ** and * indicate significance level at 1%, 5% and 10% respectively.

An International Journal JSCDSS
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6. Conclusions

Through consistence empirical examinations, the research has met its objective in analyzing formal institutional risks as well as their interaction effects on the performance of firms in emerging market economies. The major finding of this research can be summarized according to each objective as follow. First, the objective one of this research is to examine the effects of formal institutional risks on firm performance in 39 emerging market economies. Major finding of this objective can be summarized as follow. There is robust evidence that improvement of aggregate institutional quality from very lower level has negative influence on firm performance. Only countries with quality of aggregate formal institutions reach a certain level (moderate level) so that further improvement would positively influence firm performance. Better quality of legal institutions (institutions protecting private property and enforce contract) exert a positive influence on firm performance. The higher the corruption the lower the firm performance in emerging markets. Better quality of political institutions (stable government) improves firm performance.

In short, findings for objective one indicate that the overall institutional qualities have nonlinear influence on firm performance, while different dimensions of different specific dimensions of institutions have linear effect on firm performance in emerging markets countries under preview. On the entrepreneurial side, managers and business holders can be aware that specific and most relevant formal institution risks matter the most to firm performance and profit because firms deal most of the time directly with it, e.g. renewing license, complying with regulation, and bureaucracy and government administration. On the government side, it is crucial to improve the quality of these specific institutions (e.g. political, legal and economic institutors) to ease the burden of doing business, and hence promote private sector economies and national economic growth

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