

## Global Entry Strategies: Role of Formal Institutions

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### Abstract

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This paper examines how formal institutions affect global entry strategies in developed and emerging countries. Different countries have different institutional environments; thus, adjustments may have to be made on the strategy so that it can meet the specific needs of a nation. Institutions can be divided into formal and informal types. Formal institutions comprise the judicial system, investment laws, business regulations, and property rights while informal institutions include cultures, ethics, and norms that might have an effect on the business. First, formal institutional environments are analyzed and compared from three perspectives in both developed and emerging countries, namely, business regulations, trade barriers and judicial system. Second, the reasons for firms to execute different global entry strategies in developed and emerging countries are explained. Finally, this paper highlights global entry strategies that are effective in countries with weak formal institutions and those with strong formal institutions.

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**Keywords:** Global Entry Strategies; Formal Institutions

### 1. Introduction

The rapid growth in emerging economies and globalization has brought numerous challenges to firms with respect to entry into particular markets. It is crucial that before a company develops its entry strategy into a global market, it should also consider other factors like the particular institutions that influence international trade (Eyring, 2011). Formal institutions represent the foundation of different industries and the government directives of a country, so they could have a great impact on global entry strategies. These formal institutions influence how well multinational companies can develop and execute their global entry strategies.

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Formal institutions form the basis for the rules that govern businesses in an industry and knowing such rules can influence the success or failure of global businesses. Formal institutions are defined as being regulative, cognitive, and normative activities and structures that give meaning and stability to any social behavior. The World Bank adds to the definition by stating that institutions are sets of informal and formal rules that govern the actions of organizations and individuals while in the ordinary course of business (Anand, 2002).

Formal institutions have formally accepted written rules and regulations that are to be implemented to legally construct a country and to stabilize the economy, thereby defining its regulator pillar that is meant to administer both firm and individual behavior (Peng et al., 2009). One of the biggest concerns for businesses is the unstable foreign exchange rate. It is easy to experience a huge loss when a currency falls in value suddenly. Businesses prefer to conduct operations in countries where there is low uncertainty, so as to reduce their risk of doing business. Institutional frameworks are quite relevant for the reduction of uncertainty which is lower in nations with strong formal institutions as compared to countries with underdeveloped institutional structures where formal institutions are very weak.

Formal institutions tend to vary from one country to another and they have to be carefully considered before engaging in any entry strategy. Institutional structures tend to differ especially between developed and emerging economies and they can be either strong or weak. Institutions are said to be strong when they support the voluntary exchange underpinning the effective market mechanism, and are weak if they undermine markets or even fail to ensure the effectiveness of such markets. Most businesses often choose to penetrate foreign markets that seem to have formal institutions that are either similar or stronger than those in their parent locations.

However, there is a trend for businesses to move into emerging economies with weaker institutions despite the risk of uncertainty being higher. For businesses to succeed when they expand their businesses to nations with either strong or weak formal systems, they need to analyze the institutional environment and adapt to the global strategy that can guarantee success even in emerging economies that offer great opportunities for development (Tonoyan, 2010). This research focuses on the formal institutional differences that are often found between developed economies and emerging economies and examines how they affect the global entry strategies of multinational companies.

The institutions that will be analyzed in this paper are business regulations, trade barriers, and property rights. The research seeks to analyze how the differences between developed and emerging countries on formal institutions influence global entry strategies of firms when they decide to penetrate global markets. Its main purpose is to proffer viable market entry strategies that multinationals can use when gaining entry into either an emerging or a developed economy. Specific research questions that will be answered in this research are:

- i) In terms of the global market, what are the differences between developed and emerging economies with respect to the institutional environment?
- ii) What is the impact of these differences on a firm's global entry strategy?
- iii) What are the global entry strategies that are effective for countries with weak formal institutions and for those with strong formal institutions?

## **2. Formal Institutions in the Global Market**

### ***2.1 Business Regulations***

All corporations gaining entry into foreign markets are subject to local regulations that guide the establishment process of business, and are considered as new ventures. Most SMEs (Small and Medium-sized Enterprises) that get into business often engage in entrepreneurship by identifying and exploiting opportunities that have not been explored before. SMEs are the pillar of any private sector at all levels in developing countries as the contributions they make towards economic performance are significant and universally accepted. Since every nation has its own institutions, when entering into different countries, new ventures need to consider and obey different rules and regulations.

The procedures for registering a business vary across countries in matters regarding obtaining permits, notifications, verifications, and licenses. The developed economies are friendlier to startup businesses as compared to emerging economies because it takes a shorter time to register a business in the latter. For instance, the data from the World Bank in 2015 shows that it takes 2.5 days to register a business in Australia, 1.5 days in Canada, 5.6 days in U.S and 10.5 days in Germany. However, in emerging countries, it takes a much longer time to start up a business; for example, it takes about 83 days in Brazil, 50 days in Bolivian, 31.4days in Chinaand 29 days in India (The World Bank, 2015).

The ease of starting a business in a nation also determines the ease of doing business that involves dealing with construction permits, registration of property, protection of investors, payment of taxes, enforcement of contracts, and closure of business (Tonoyan, 2010).

Developed economies are preferred when it comes to global expansion because they have economies that are friendly to entrepreneurship. These economies have properly structured institutional frameworks that are quite effective in lowering the costs involved with establishing a business. Therefore, new businesses that are based in emerging economies should quickly expand their activities to developed economies in order to enjoy business freedom that entail shorter start up processes, reduced procedures, and lowers costs of setting up a business. Data from The World Bank in 2015 shows that in Australia, it takes only 3 procedures to set up a business, 2 procedures in Canada, 6 procedures in U.S. and 9 procedures in Germany.

In contrast, 15 procedures are required in Bolivia, 12.9 procedures in India, and 11 procedures in China and Brazil. The cost associated with starting a new business can be equated to 0.7% of income per capita in Australia, 0.4% in Canada, 1.1% in U.S. and 1.8% in Germany. However, the cost associated with starting a business is much higher in emerging countries; in Bolivia it is 57.9% of income per capita, 78.7% in Cambodia and 13.5% in India. Regarding the ease of doing business, according to The World Bank, among the 189 countries, U.S has a rank of 7, Australia is 13, Canada is 14 and Germany is 15. On the other hand, most emerging countries have a lower rank, for example, China has a rank of 84, Brazil is 116, Cambodia is 127 and India is 130 (The World Bank, 2015). According to the data shown, the business environment is much friendlier in developed countries. Moreover, business are well-protected by the strong institutions that motivate more business formations and innovations.

## **2.2 Trade Barriers**

Many countries have put restrictions on free trade. These may be classified into three types: tariff and nontariff barriers, restrictions on entry modes, and local content requirements. The non-tariff barriers include manufacturing and agricultural subsidies, import restrictions, and quotas. Governments often impose these barriers to protect their domestic corporations through the adverse effects of foreign competition and also to collect revenue.

When trade barriers are utilized on a worldwide scale, they increase the costs of companies thus making it less viable to conduct business. Emerging countries tend to have much higher trade barriers when compared to developed countries because they highly rely on trade taxes for revenue. Developed economies have trade-friendly environments that are regulated by strong institutional frameworks responsible for controlling tariffs and other trade restrictions.

Emerging economies, on the other hand, have a very restrictive trade environment where they impose higher trade barriers in the belief that they are protecting their domestic firms. A good example of a nation that engages in setting high trade barriers is India which applies high tariff rates in a bid to raise revenue for government operations. For a low income country, import taxes are an important source of income and are much easier to collect when compared to other sources of income. India, for instance, has a 7.9% weighted average tariff rate where high tariff rates are reported on agricultural products (Meyer, 2009). In order to protect its domestic market from injury, the country implements strict anti-dumping protection laws to deter foreign corporations from penetrating the market and imposes various kinds of custom taxes on all imports. Foreign direct investment is heavily curtailed where no foreign investments are allowed on land and there are other restrictions in many industries. Emerging economies like India often pursue unofficial policies that favor local companies thereby discouraging foreign investors.

Research has shown that the TRI (Trade Restrictiveness Indices) tend to be higher in emerging countries. For example, the TRI in Canada is 0.191, in Australia is 0.250, in U.S is 0.294 and in Switzerland is 0.247. In contrast, the TRI in Brazil is 0.497, in India is 0.469, in Algeria is 0.557 and in China is 0.343. This suggests that richer countries are more likely to impose lower trade barriers on imports. However, the poor countries tend to impose heavier trade barriers (Hiau Looi Kee et al., 2009).

### **2.3 Judicial System**

The judicial system is another formal institution that has an important role in global business. Getting involved in lawsuits is quite common in doing business in other countries where firms are not very familiar with the regulation, rules, culture and language. However, in most emerging countries, the judicial system is not well-developed and often involves corruption.

This makes doing business more complicated because instead of just following the regulations, firms need to follow the “underground rules” as well. On the other hand, in developed countries, the judicial system is more mature and trustworthy. According to Transparency International, the Corruption Perceptions Index 2015 (on a scale of 0 (highly corrupt) to 100 (very clean)) lends support to the perspective that in emerging countries, the judicial system is not trustworthy due to severe corruption problems.

For example, the Index in India is 38, in Vietnam is 31, in Cambodia is 21 and in South Sudan is 15. Obviously, the above-mentioned countries are categorized as emerging countries. In contrast, the Index in developed countries is much higher than in emerging countries. For example, Denmark is ranked 91, Norway is 87, Germany is 81 and U.S is 76 (Transparency International, 2015). It is easier for a multinational company which has sufficient resources and personal network to gain entry into emerging countries with weak judicial systems. However, for SMEs, it is much harder to do business in the countries with weak judicial system since most of them don't have enough resources to deal with “underground rules”.

### **3. Managerial Implications**

There are formal institutional differences between emerging economies and developed economies and these have a critical impact on the global strategy of a business. When entering developed economies, the process calls for a different global strategy as compared to when gaining entry into an emerging economy. For example, new ventures will be treated differently in emerging economies than in developed economies and this is a fact that businesses need to take into account seriously if they want to succeed. Gaining entry into emerging countries can be more costly and risky as compared to gaining entry into developed countries where the business start-up procedures are much simpler and taking shorter time.

Furthermore, it is easier for a multinational company to gain entry into emerging countries as compared to SMEs as they can take advantage of economies of scale to enjoy reduced costs and they might receive extra support from the government. It is easier for SMEs to gain entry into developed countries because of lower capital requirements, simpler start-up procedures and taking much shorter time. Below we will discuss the appropriate types of global entry strategy that can be used by corporations when gaining entry into both emerging and developed economies.

### **3.1 Global entry strategies for emerging economies.**

Entry barriers are quite high in emerging economies and they often determine the kind of strategy that an organization can use to enter a particular market. These economies are often not quite friendly to FDI (foreign direct investment) and put many limits on FDI, especially in certain sectors that they consider significant to domestic industries. Due to such restrictions, market entries into emerging markets could be done through joint ventures and contractual agreements.

#### *a) Joint ventures*

A joint venture is simply a partnership between an international company or a company seeking to enter the new market and a local company that has been operating in the market for a certain period. The international company has to ensure that it has a big enough equity stake in the partnership to have control of the business but not necessarily enough to completely dominate that venture. Such an entry strategy would ensure that the company benefits from the complementary advantages offered by the local company such as local connections, knowledge and understanding of local cultures and customs.

#### *b) Contractual agreements*

These are often referred to as strategic alliances where two corporations, the international company and a local company, enter into an arrangement to enhance their competitive advantage. The objective here is to share research and development, marketing relationships, manufacture-supplier relationships, and technological swaps in order to boost one another. Such an entry strategy would be beneficial to the international company as it allows it to enter the market quickly while reducing the political and economic risks of doing business in the emerging economy.

### **4.2 Global entry strategies for developed economies.**

The trade environment is considerably liberal and highly favors FDI in developed economies. Two market entry strategies that are highly effective in developed economies are Greenfield operations and acquisitions.

a) *Greenfield operations*

This is a strategy where the parent company decides to establish a completely new subsidiary in the developed country that it wants to do business in. Even though such ventures require large capital investments, they are viable in the long term especially if the corporation has a competitive advantage that is based on technological competency. Since institutions are well coordinated, intellectual rights protected, and easy setup of business is guaranteed in a developed economy, such an entry strategy is less risky and quite effective.

b) *Acquisitions*

This is an expansion strategy into a new market where an international company buys off a corporation in the local market that is in line with its business. Organizations usually pursue acquisitions in order to increase their market power in the new market, minimize the risks involved, and acquire any technology that might improve their production process. This is a viable plan in a developed economy since the acquisition process is well documented and proper institutions can facilitate the process thereby ensuring the company is in business within the shortest time possible (Anand, 2002).

#### **4. Informal Institutions In the Global Market**

Although this paper focuses primarily on the role played by formal institutions, we should not overlook the salient impact of “informal” institutions such as cultures, ethics, and norms on the success of global business. For example, it is widely recognized that a thorough understanding of culture and customs is necessary for foreign business success; yet, it is generally more difficult to measure how informal institutions affect business. It is worthwhile to note the similarities that are exhibited within developed countries themselves and also the similarities exhibited among emerging countries themselves. However, the differences can be significant between developed and emerging countries.

For instance, when taking a look at the Gender Inequality Index from UNDP in 2014 (United Nations Development Program), the indices among developed countries are similar and those among emerging countries are also similar.



For example, the index of Germany is 0.041, Australia is 0.110, and Canada is 0.129 and that of USA is 0.28; while the index of India is 0.563, Bolivia is 0.444, and Cambodia is 0.447 and 0.457 in Brazil. Second, when we look at ethical indices such as the Corporate Ethics Index (CEI) and the Public Sector Ethics Index (PSEI), we also find similarities within each category. For example, for Australia the CEI is 71.1 while the PSEI is 78.6; for Germany, CEI is 73.7 and PSEI is 74.3; for U.S, CEI is 57.4 and PSEI is 70.1, and for Canada, CEI is 63.1 and PSEI is 59.7.

In contrast, the CEI and PSEI scores are much lower in emerging countries. For example, in Bolivia, CEI is 19.1 and PSEI is 14.5; in Brazil, CEI is 35.4 and PSEI is 35.2; in India, CEI is 34.6.1 and PSEI is 31.7, and in Vietnam, CEI is 34.1 and PSEI is 29.7(Kaufmann, 2004). According to the above data, the informal institutional environments of developed countries tend to be similar and a similar pattern is also observed in emerging countries. Hence, before multinational companies gain entry into a new market, it is crucial that they consider not only formal institutions but also informal institutions. Furthermore, the informal institutional environments tend to be quite different between developed and emerging countries.

## **5. Conclusion**

The drive towards globalization has significantly changed the social, political and economic landscape. The business environment has been profoundly affected, both negatively and positively, by the globalization policies implemented in various geopolitical regions. Globalization has broadened and diversified labor and commodity markets, enabling companies the opportunity to diversify their employee and customer bases.

However, globalization has also created the problem of heightened competition and the lack of a uniform policy across various regions. Understanding and adapting to these changes is imperative for success in the global business arena. This research has established that there are fundamental differences between formal institutions in developed economies and those in emerging economies. It is imperative that businesses consider the kind of differences that exist in institutional structures before making a decision on the most effective entry strategy that they want to engage in. In emerging economies, there exists weak institutional frameworks that favor joint ventures and contractual agreements market entry strategies. In developed economies, there are strong institutional structures that can support Greenfield operations and acquisitions market entry strategies.

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