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Institutional Reform and Entry Mode by Foreign Firms: The Case of Jordan

Summary

This paper investigates the links between institutional systems and the entry mode of Multinational Corporations (MNCs) in developing and transition countries (DTCs). An assessment is made of the reasons for the continuing use of international joint ventures (IJVs) in countries that have undergone reforms intended to lead to the development of wholly owned subsidiaries. The paper argues that formal and informal institutional constraints in DTCs lead to high transaction and uncertainty costs for MNCs, and that the use of IJVs is a rational response to attempt to lower these high costs. The paper follows the literature suggesting that IJVs are normally a 'second best' entry mode in terms of the potential for foreign direct investment (FDI) to contribute to the development of DTCs. The reform process in Jordan is used to illustrate how institutional systems, especially informal institutional constraints, lead to high transaction and uncertainty costs. In the case of Jordan, this occurred despite a series of four reform packages seeking to reduce the institutional barriers to effective business activities. Interviews of 28 foreign companies provide the basis for an empirical assessment of the importance of both formal and informal institutional constraints and infrastructure problems. The paper includes an outline of a future research agenda that seeks to generalise and develop the results from Jordan to other DTCs.

1. Introduction

The bulk of Foreign Direct Investment (FDI) into developing and transition countries (DTCs) has been by International Joint Ventures (IVJs) (UNCTAD, 1995; World Bank, 1996). The traditional explanation for the extensive use of IJVs in DTCs is that legal restrictions, such as prohibitions on full ownership, uncertainty over property rights and taxation systems, limit the development of wholly owned subsidiaries. Many DTCs have reformed their formal institutional systems to reduce or remove these obstacles to full ownership, thereby hoping to promote DFI inflows more helpful to the development process. Formal institutional constraints include political and legal procedures, as well as government agencies that control and regulate economic and social activities. Reform of formal institutional systems does not, however, necessarily mean that informal institutional constraints are altered in such way that the reforms become effective. Informal institutional constraints include norms of behaviour and attitudes to the procedures used in operating formal institutional systems.

The paper begins with an overview of the orthodox position, which identifies formal institutional constraints and cultural factors as the main obstacles to FDI inflows. There is a review of the emerging literature focusing on problems associated with corruption and regulatory burdens which impede FDI inflows. This provides the background for an analysis of institutional constraints as a major inhibitor of FDI inflows. The analysis of informal institutional constraints provides a framework suggesting that these constraints can lead to high uncertainty and transaction costs for 'outsiders' (foreign investors), and that this induces the use of IJVs able to provide a viable, but 'second best', alternative to full ownership. A review of the reforms in Jordan, and of the continuing problems of attracting DFI there, highlights the continuance of institutional constraints that lead to high transaction costs, thereby inhibiting the development of wholly owned subsidiaries. Interviews of 28 foreign investors in Jordan provide an empirical assessment of the importance of informal constraints as a barrier to the use of alternatives to IJVs. The paper concludes with an outline of a future research agenda, which should improve and expand our understanding of the importance of institutional factors for the development of the subsidiaries of MNCs in DTCs.

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2. Limitations to FDI in DTCs

The traditional literature on obstacles to FDI in DTCs is centred on the role of risk factors, such as poor infrastructure, arbitrary taxation and regulatory systems, as well as exchange and capital control policies that hamper the operations of MNCs. High risk in these areas is considered to discourage MNCs from investing in developing countries (Brewer, 1993; Kobrin, 1979; Thomas and Worrall, 1994). Cultural differences also add to the risks of investing in DTCs (McCarthy, Puffer and Simmonds, 1993; Schlegelmilch, Diamantopoulos and Petersen, 1991). The combination of these problems is considered to result in high costs for 'outsiders' (MNCs) entering such countries, and acts as an incentive to seek the assistance of 'insiders' (local partners) to reduce these risk factors.

The use of IJVs reduces these risks by linking MNCs to domestic agents who have experience, knowledge and contacts which help foreign companies to operate effectively within the institutional system of the host country. In DTCs, therefore, the incentive to use IJVs appears to be mainly due to problems associated with institutional factors, such as bureaucratic and taxation rules, which inhibit the development of wholly owned subsidiaries (Meyer, 1998; Wheeler and Ashoka, 1992). In contrast, the incentive to use joint ventures, including IJVs, in developed economies is connected to a variety of strategic reasons, such as achieving economies of scale, rationalisation of operations, exchanging or gaining access to new technologies and resources, and penetrating markets (Harrigan, 1988). Although IJVs offer a means of reducing the high transaction and uncertainty costs associated with institutional systems in DTCs, they normally provide a 'second best' solution for capturing the benefits of FDI. The problem with IJVs is that they are prone to instability and arguments over the distribution of profits, and that they have high risks associated with loss of intellectual property (Buckley and Casson, 1996). These risks make MNCs reluctant to transfer technologies embodying the best products, production, and marketing and distribution systems (Inkpen and Beamish, 1997; Smarzynska and Wei, 2001).

The problems posed to DTCs by poor institutional systems are recognised in the literature (Aswicahyono and Hill, 1995, Gobermann and Shaprio, 1999). Indeed, political and economic stability, together with legally enforceable safeguards for physical assets and intellectual property, is considered essential to attract even low levels of FDI (UNCTAD, 1998). This literature focuses on the need to develop formal institutional constraints, such as well-defined property rights and effective government policies and agencies to control and regulate economic activity. The impact of informal institutional constraints on FDI inflows is mainly considered in reference to the differences in cultural values between home and host countries. The solution to differences in cultural values is normally related to the design of management systems that can effectively operate within the context of the different cultural values prevailing in various countries (Hofstede, 1994). The cultural values approach has been developed by the introduction of the concept of psychic distance, whereby differences in business practices, legal systems and language are added to the cultural dimensions of Hofstede (O'Grady and Lane, 1996). However, the psychic distance approach does not fully capture the concept of informal institutional constraints, because the focus is on formal institutional factors, such as the characteristics of legal systems, the nature of the competitive environment and regulatory frameworks. In the psychic distance approach, informal institutional constraints are mainly captured by variables that seek to measure problems with languages and differences in cultural values. Moreover, empirical studies based on the concept of psychic distance tend not to discover any significant systematic relationships between psychic distance and organisational performance (Statlinger and Schlegelmilch, 1998).

Contemporary consideration of the impact of informal institutional failings on FDI inflows is focused on the importance of factors such as corruption, administrative malfunction, arbitrary taxation and regulatory frameworks regarded as inhibiting investment. Commercial organisations have used these types of institutional factors to develop competitiveness indices, for example, the Global Competition Report, the World Economic Forum Survey and the opacity index of Pricewaterhouse Coopers. International institutions have also formulated policies to counter the harmful affects of these institutional failings (World Bank, 1997a, OECD, 1999). Furthermore, academics have sought to develop and test theories on the relationship between institutional failings (particularly corruption) and investment (Smarzynska and Wei, 2001; Wei, 2000; Habib and Zurawicki, 2001). Work on the influence of institutional failings on modes of entry focuses on the trade-off (when using IJVs) between the benefits of helping to deal with difficult institutional systems and the risk of opportunistic behaviour by local partners leading to expropriation of assets and low returns to foreign investors (Henisz, 2000).

The preparations for the 1997 World Bank Report, and the aftermath of this report, led to efforts by the World Bank to find evidence of the impact of institutional failings by surveying firms in order to assess the major institutional obstacles to business operations (Brunetti et al, 1997; Kaufmann et al, 1999;

Pfeffermann and Kisienko, 1999). This work led to the establishment of a World Business Environment Survey (WBES) to assess the impact of institutional failings on the performance of firms (www.worldbank.org/wbes.htm). The WBES has generated a database by integrating surveys of firms in 90 countries, thus providing a comprehensive overview of the impact of institutional failings on business activities.

This work reveals that investments by both MNCs and domestic investors are adversely influenced by institutional failings in DTCs. Many of these failings are linked to formal institutional factors, but informal institutional failings, such as corruption, crime, administrative malfunction and the arbitrary enforcement of taxation and regulatory frameworks, are increasingly seen as significant obstacles to the operational effectiveness of MNCs in DTCs. Most of this work, however, focuses on the importance of corruption.

Using the literature on institutional failure and new institutional economics as a guide, the links between institutional systems and transaction and uncertainty costs, as well as the implications for entry mode, are outlined in order to provide a conceptual framework that highlights the main reasons for the use of IJVs. This framework forms the basis for an empirical study of the influence of institutional failings on entry mode.

3. Transaction Costs and Institutional Frameworks

Transaction cost theory indicates that institutional frameworks can facilitate low cost exchange by reducing the transaction and uncertainty costs associated with exchange (Williamson, 1985; Williamson, 1998; Matthews, 1986). New institutional economics argues that the characteristics of institutional systems are path-determined by history, and that fundamental change to formal, and especially informal, constraints can only emerge slowly as societies adjust to changing circumstances (North, 1983, North, 1990, North, 1994). Another important aspect of new institutional economics is the effectiveness of adjusting institutional constraints in response to economic, political, social and technological change. This has been termed the adaptive efficiency of institutional systems (North, 1990). The adaptive efficiency of institutional systems is an important factor for the level of transaction and uncertainty costs in conditions of rapid economic, political, social and technological change (North, 1999).

At the heart of the analysis of the importance of institutional frameworks are the types of exchange that are possible within given institutional frameworks. Three main types of exchange are considered by North, (1990):

1. Personalised exchange systems are based on repeated dealings within culturally homogenous blocs, for example, extended families or primitive tribal groups. These systems depend on high levels of trust or hostage mechanisms ensuring that implicit contracts are honoured. They have low transaction and uncertainty costs if exchange is restricted within a homogenous bloc. This type of exchange reduces specialisation because only a small number of agents (members of the family or tribe) are included in the exchange system. These systems normally have poor adaptive efficiency and often disintegrate when confronted by minor economic, social or technical changes.

2. Impersonal exchange systems without third party enforcement are based on groups (tribes, guilds, networks) that have shared values and informal enforcement processes which establish trust or hostage mechanisms to ensure that implicit contracts are fulfilled. This type of exchange has low transaction and uncertainty costs if the informal enforcement procedures are effective. However, they limit specialisation and potential trading partners to agents who are members of the tribe, guild or network. These systems find it difficult to take advantage of the benefits of wider trading opportunities and to reap economies of scale and scope. They also tend to have poor adaptive efficiency and often find it difficult to adjust to economic, political, social and technical change.

3. Impersonal exchange systems with third party enforcement may make use of trust or hostage mechanisms based on tribal, guild or network arrangements, but have formal systems, such as laws, courts and regulatory agencies, which act as third party enforcers of explicit and, in some cases, implicit contracts. Moreover, informal constraints support the formal institutional systems and thereby help to enforce explicit and implicit contracts. Systems of this type have developed formal and informal institutional systems that are able to create, maintain and develop the conditions that permit impersonal exchange with low transaction and uncertainty costs. This type of exchange permits substantial levels of specialisation and a large pool of potential traders with whom it is deemed safe to do

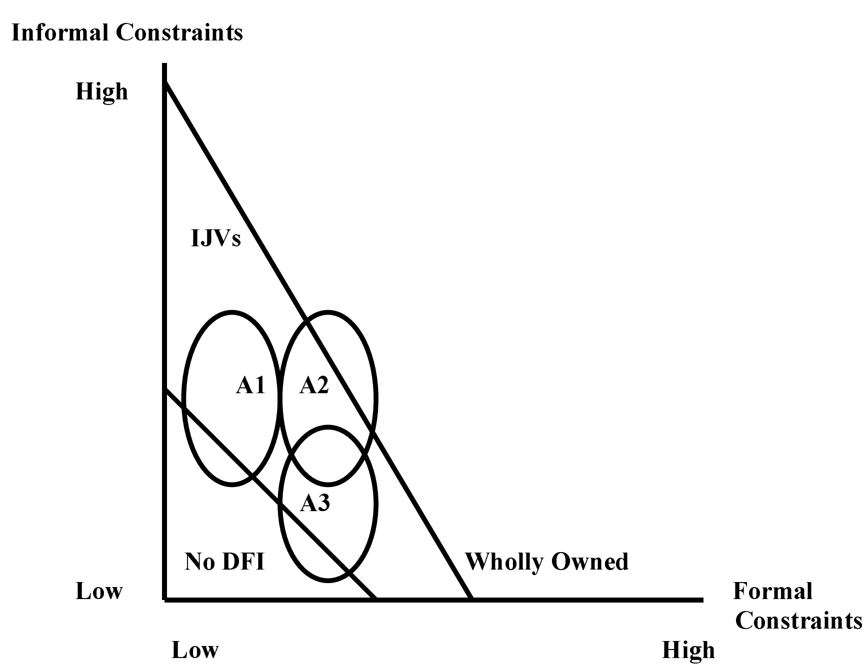
business. Moreover, they have high levels of adaptive efficiency, allowing quick adjustment to new conditions arising from economic, political, social and technical change.

To achieve effective impersonal exchange with third party enforcement, DTCs need to create and develop institutional systems with formal and informal institutional constraints that deliver low transaction and uncertainty costs. This raises the question as to why many DTCs appear to be failing to achieve such an outcome. The answer to this conundrum, according to new institutional economics, is that the creation of institutional structures involves large sunk costs arising from the process of creating and implementing new institutional frameworks (North, 1990). Therefore, there are strong vested interests that seek to retain the *status quo* by avoiding the costs of substantial institutional reform. To overcome these vested interests there must be powerful reasons to change these frameworks. Furthermore, the feedback on outcomes from existing institutional structures (to the various actors involved) is often asymmetrically distributed, incomplete and slowly disseminated. Under these circumstances, changes to the formal and informal constraints on human interaction are normally very slow. Institutional evolution is, therefore, largely the result of the realisation by actors that a new round of institution building is necessary, and that sunk costs must be incurred in this process. Incurring such costs is justifiable if the cost of existing outcomes exceeds the sunk costs necessary to build new institutions, or to modify existing institutional frameworks. In most cases, change will be incremental because the various actors are likely to have different ideas and information about the size of the sunk costs and the costs associated with existing outcomes, thereby making it difficult to agree on significant changes to institutional structures. These factors explain why institutional systems that are ineffective can be constructed and sustained. Societies can, therefore, inherit stable but ineffective institutional structures based on a set of beliefs, resources and power bases determined by history (Akerlof, 1976; Argyres and Liebeskind, 1999). Under these circumstances, it is unlikely that actors will make dramatic changes from the path they have been following (Zucker, 1986).

4. Exchange Systems and Mode of Entry

Societies that have poor institutional systems are not able to sustain effective impersonal exchange with third party enforcement and, consequently, ‘outsiders’ face high uncertainty and transaction costs. A solution to this problem is to reduce the transaction and uncertainty costs for ‘outsiders’ by their linking to agents who operate within ‘insider’ arrangements, such as tribal or guild-type organisation. Thus, joint ventures, or other types of collaborative arrangements between ‘insiders’ and ‘outsiders’, provide a means to reduce the high transaction and uncertainty costs that afflict ‘outsiders’ wishing to operate in societies that have poor impersonal exchange with third party enforcement. The links between institutional systems and modes of entry are illustrated in Figure 1.

Figure 1: Institutional Constraints and Mode of Entry



The lines in Figure 1 define the possible areas for different modes of entry. The slopes of the lines are determined by the trade-off between higher levels of informal constraints and lower levels of formal institutional constraints. The slopes of these lines may be non-linear, indicating complex trade-offs between formal and informal constraints. An increase in the transaction and uncertainty costs associated with the possible combinations of formal and informal institutional constraints would shift the lines closer to the origin. The lines indicate boundaries to entry mode type, based on the transaction and uncertainty costs for all possible combinations of formal and informal institutional constraints. The gaps between the lines indicate the areas where different types of entry mode are appropriate, given the transaction and uncertainty costs associated with different institutional systems.

The areas A1, A2 and A3 represent the space that MNCs face when selecting entry modes. A move from A1 to A2 reflects institutional reform that only influences formal constraints. Under these circumstances, IJVs become more attractive and wholly owned subsidiaries become a possible entry method. However, reform of formal constraints that lack legitimacy may worsen informal constraints by generating resentment among members of the society who do not agree with the reforms. This can lead to the growth of tribal or guild-type economic activity conducted largely outside the formal institutional system. Such a development would impose costs on 'outsiders' such as MNCs, thus leading to a downward movement in the available space for entry by MNCs to, for example, A3. This would reduce the potential to attract IJVs and discourage the evolution of wholly owned subsidiaries.

The reforms of government policies and agencies that are common in many DTCs may fail in many cases because they are often based on the use of blue prints for institutional systems that come from developed countries. Moreover, these programmes focus on changes to the formal constraints on institutional systems, whereas informal constraints are arguably of more importance in developing effective exchange with third party enforcement. Many DTCs have engineered substantial changes to the formal constraints of institutional systems, but this has not led to significant improvements in economic development. The problem is that the informal constraints have not been sufficiently adjusted and, in many cases, the reform to formal constraints is not accepted by the people who have to operate within the new institutional systems. Therefore, these countries continue to operate on a tribal, guild or informal network basis, making it difficult for MNCs to expand the use of IJVs and begin to develop wholly owned subsidiaries. In cases where reforms lack legitimacy among groups within the society, they may encourage the growth of informal guild-type behaviour that increases the transaction and uncertainty costs to 'outsiders'.

Solutions to these problems require DTCs to transform the informal constraints in their institutional systems. The reforms must also develop good adaptive efficiency so that rapid adjustments can be made in response to changes forced on the business environment. Furthermore, the reforms to formal constraints must be legitimate and acceptable to the people. Societies that are unable, or unwilling, to induce such changes in their formal and informal constraints are likely to face widespread use of sub-optimal IJVs.

5. Reforms to the Institutional System of Jordan

The case of institutional reform in Jordan illustrates the limitations that arise when reform is centred on formal institutional systems. Since 1989, Jordan has engaged in four stabilisation and structural adjustment reform packages enforced by the IMF and the World Bank. These reforms have led to reductions in tariff and non-tariff barriers, liberalisation of price controls, and privatisation of a number of state-owned enterprises. The Jordanian government also sought to encourage foreign investment by introducing a new investment law in 1995 (modified in 2000) that provided financial incentives to foreign investors, eliminated state restrictions on wholly owned subsidiaries and simplified bureaucratic measures connected with foreign investments. The strength of these reforms qualified Jordan for membership of the WTO, in January 2000.

The political and security situation in the Middle East has had a profound impact on FDI into Jordan. One of the effects of the situation in the Middle East is that Jordan has experienced a large inflow of Palestinian immigrants, leading to investments and strong economic links to other states, especially in the Gulf. This has created special conditions that impact on DFI into Jordan. The political and security situation also influences Israeli DFI inflows into Jordan. Under normal conditions, DFI from Israel would be very important for Jordan because investment flows are normally high between countries that are geographically close (Dunning, 1998a and b), but the political and security position makes such investment very difficult. However, these special circumstances, including the barriers to DFI by Israel, are not considered in this paper, which focuses rather on general obstacles to investment in Jordan. These obstacles are likely to persist even if the political and security situation in the Middle East were to dramatically improve.

Improvements in the political and security situation following the 1994 peace treaty between Jordan and Israel did have an important impact on FDI in Jordan, due to the provision by the USA of duty free entry into its market for firms operating in special Qualifying Industrial Zones (QIZ). Five QIZs have been established, and production and exporting from these zones began in late 1997 (JIB, 2000).

Despite large-scale liberalisation and privatisation to promote foreign investment in Jordan, most of this investment is based on IJVs rather than on wholly owned subsidiaries. The only sector where wholly owned subsidiaries can be widely found in Jordan is in the QIZs. Before the establishment of QIZs, wholly owned subsidiaries hardly existed in Jordan, except in some service-oriented projects. As the General Director of the Investment Promotion Corporation (Reem Badran) stated: "Foreign investors prefer to have full control over their investment projects. But this is not the case in Jordan. Most FDI in Jordan takes the form of joint ventures, share holding and management contracts (mainly in hotels), and strategic alliances." (Interview, July 1997, Amman).

6. Sources of High Transaction Costs in Jordan

Jordan has several sources of inefficiencies that increase transaction costs (Sha'sha, 1991). The persistence of a tribal mentality in Jordan, which restricts business activities for people outside well-placed tribal groups, is one of the most important sources of high transaction costs for 'outsiders' (Layne 1987). The personalised approach to business in Jordan is further amplified by the problem of Wasta, which literally means to employ a middleman, or an intermediary, who secures access to the right decision makers. The use of Wasta is normally essential for firms requiring import, export and production licenses, and for those who need to demonstrate that they have complied with rules and regulations. In some cases, Wasta can significantly reduce tax liability and can ease the requirement to comply with regulations (El-Said, 1996; El-Said, 2001).

Another source of high transaction costs in Jordan is Bukrah (tomorrow) and Inshalla (God willing) attitudes that can lead to long delays in processing normal business activities. Moreover, public officials in Jordan normally require firms to play elaborate rituals of introduction before getting down to business. This leads to frustration and high transaction costs for foreign investors. An American investor highlights the demands on his time arising from this attitude: "This makes the way of doing business in Jordan different from the British, Japanese or American way. I can get the job done in 30 minutes in the US or the UK, but it takes me three to four days in Jordan." (Interview, Amman, 1997).

Corruption represents another impediment to the efficiency of transactions in Jordan. Direct requests for money by state officials are not common. However, requests for gifts, connected to traditional cultural attitudes, are an important part of the game of human interaction in Jordan. As a Japanese investor in Jordan put it: "Everybody is asking for a contribution. We do not give cash, but we arrange for some officials to go to Japan on holiday and we cover all of the costs. Even the highest ranked Jordanian officials ask for such gifts." (Interview, Amman, 1997).

Ambiguity in the meaning of laws, and confusion over the activities and competencies of regulatory authorities, also increase transaction and uncertainty costs. Most foreign investors have stated that there are many state departments involved in activities connected with business operations, but the role of each of them is not clear. Investors often have to visit a large number of government agencies before eventually finding the right place, or the right sequence of requests, for obtaining action from state agencies. Considerable effort and resources are wasted in the process. Moreover, although laws and regulatory frameworks regarding investment in Jordan are clear on paper, their implementation is very complicated. A report by the World Bank (1997b, p40) confirmed that "a significant gap exists between the system as prescribed by laws and regulations and the system in practice. The foreign business community has voiced its concerns about these administrative problems and about the lack of consistency between policies and implementation at all levels".

7. The Study

The study is based on semi-structured interviews of 28 foreign companies carried out in 2000. The interviewees (all of them expatriates) were senior managers of firms. All of the interviews were conducted by one of the authors, a Jordanian citizen who, through his experience of completing his PhD thesis, had developed skills and knowledge on how to elicit information on the problems of doing business in developing countries.

Sixteen of the 28 firms interviewed were located in four QIZs: Al-Karak, Al-Tajammouat, Al-Hussein and Ad-Dulayl. At the time of the interviews, they represented 100 per cent of the firms operating in Al-Karak, 75 per cent of the firms in Tajammouat, 38 per cent of the firms in Al-Hussein and 80 per cent of those operating in Ad-Dulayl. Therefore, the sample is a good representation of firms operating in the QIZs. The main aim of firms operating inside the QIZs is not to serve the Jordanian or regional markets, but rather to serve the US market by taking advantage of free access to this market. The involvement of QIZ-based firms in the Jordanian market is limited to 27 per cent local content (www.jordaninvestment.com).

The sample of firms outside the QIZs is representative of foreign investment in Jordan. The twelve firms represented approximately 50 per cent of the stock of foreign investments in Jordan in 2000. The sample is also representative of foreign firms in terms of size (measured by employment), country of home parent and sector (www.jordaninvestment.com). By including firms based in the QIZs, the sample is biased towards newly established firms and towards the manufacturing sector. However, the importance of the QIZs for FDI in Jordan justifies their inclusion. Table 1 provides an overview of the characteristics of the sample.

The firms ranked the main infrastructure, formal and informal institutional obstacles to doing business in Jordan (see table 2). The selection of potential obstacles in the infrastructure and formal institutional categories was informed by the approach used by the World Bank to investigating these issues (World Bank, 1997a, Kaufmann, 1999). The choice of factors for informal institutional obstacles was also influenced by the approach of the World Bank, but the selection of terms used was, in the case of three factors (tribal mentality, Wasta and Inshalla), specific to Jordanian

Table 1: Characteristics of Interviewed Firms

Country and start date in Jordan	Sector	Type of Investment ( )	Employment	Markets supplied (%)			
				1	2	3	4
1. Japan 1997	Manufacturing	JV (52%)	2500	70	20	10	na
2. Japan 1992	Manufacturing	JV (40%)	109	5	95	na	na
3. Japan 1997	Manufacturing	JV (40%)	39	100	na	na	na
4. Japan 2000	Trading	WO	5	90	10	na	na
5. Japan 1997	Trading	WO	9	70	30	na	na
6. Japan 1975	Trading	WO	4	25	65	na	na
7. UK 1995	Manufacturing	JV (25%)	52	10	90	na	na
8. France 2000	Telecoms	JV (65%)	4800	100	na	na	na
9. France 2000	Bank	JV (62%)	220	70	30	na	na
10. France 1984	Services	WO	25	60	40	na	na
11.Sweden1997	Services	WO	30	60	40	na	na
12. NL * 2000	Manufacturing	JV (50%)	750	na	na	15	85
13. USA 2000	Services	WO	na	95	5	na	na
14. USA* 2000	Manufacturing	JV (50%)	120	na	na	na	100
15. USA* 2000	Manufacturing	WO	890	na	na	na	100
16. USA* # 2000	Manufacturing	JV (80%)	120	na	na	na	100
17. HK * 2000	Manufacturing	WO	350	na	na	na	100
18. HK * 2000	Manufacturing	WO	660	na	na	na	100
19. HK * 2000	Manufacturing	WO	1000	na	na	na	100
20. Taiwan *2000	Manufacturing	WO	600	na	na	na	100
21. China * 1999	Manufacturing	JV (26%)	1800	na	na	na	100
22. China * 1999	Manufacturing	WO	2000	na	na	na	100
23. Pak * 2000	Manufacturing	JV (50%)	600	na	na	na	100
24. Pak * 1999	Manufacturing	WO	1200	na	na	na	100
25. Pak * 2001	Manufacturing	WO	170	na	na	na	100
26. Pak * 2001	Manufacturing	WO	52	na	na	na	100
27. Pak * 2000	Manufacturing	WO	35	na	na	na	100
28. Pak * 2000	Manufacturing	WO	450	na	na	na	100

* Located in QIZ
1 Jordan 2 Middle East and North Africa 3 European Union 4 USA
USA/Lebanese firm
( ) Share of JV held by Jordanian partner

conditions. This was done in order to capture the role of important informal institutional obstacles to effective business operations in the Jordanian context.

8. Results

The results reveal that wholly owned subsidiaries are in the minority of the firms that are not located in the QIZs (see table 1). Wholly owned subsidiaries not in QIZs are restricted to firms that are small, in terms of employment, and that are in the trading or service sectors. All of the manufacturing firms and large employers strongly involved in the Jordanian or Middle East and North African markets were IJVs. Moreover, firms not in QIZs that were established after the main reforms in Jordan, that is in the post 1995 period, tend to be IJVs.

Informal, formal and infrastructure problems are all revealed as obstacles to effective operations by foreign investors (see table 2). In terms of significant problems (in the top three obstacles), those associated with formal and informal institutional systems were generally regarded as more significant than difficulties with infrastructure. Problems of finding skilled workers, along with poor logistical systems, were the most important reported infrastructure obstacles. Seven formal and informal institutional factors were considered more important than infrastructure obstacles (other than lack of skilled workers and poor logistical systems) – the attitude of bureaucrats, investment incentives, governmental administration systems, tribal mentality, pace of reforms, Wasta and clarity of rules. Nine formal and informal institutional obstacles were regarded as more serious problems than half of the infrastructure problems. Corruption was not high on the list of significant problems, compared to other formal and informal institutional factors. In fact, four infrastructure problems were listed as more significant problems than corruption.

The top ranked problem was lack of skilled workers, but the next four top ranked problems were institutional factors (two formal and two informal) - governmental administration systems, investment incentives, attitude of bureaucrats and tribal mentality. Corruption was only indicated as a top ranked problem by 4% of firms, the same as two of the infrastructure problems – water supply, and roads and transport. Three of the infrastructure obstacles were not recorded as a top ranked problem by any firms – marketing systems, electricity supply and telecom services.

Informal institutional factors were revealed as the top ranked obstacle for the total sample (see Figure 2). However, the difference was not large - 36% for informal obstacles, and 32% for both formal and infrastructure obstacles. Firms in QIZs had the lowest level of top ranked problems for informal institutional obstacles - 25% compared to 37.5% for formal and infrastructure obstacles. Those firms not in QIZs ranked informal institutional obstacles as the top problem, with 50% as compared to 25% for formal and infrastructure obstacles. Wholly owned subsidiaries reported a higher top ranking for formal institutional and infrastructure obstacles than for informal institutional obstacles. IJVs ranked informal institutional obstacles as the top problem, with infrastructure problems second and formal institutional problems third. Wholly owned subsidiaries reported higher levels of top ranking for formal institutional obstacles than IJVs. Informal institutional and infrastructure obstacles received more top ranking by IJVs than by wholly owned subsidiaries.

Table 2: Infrastructure, formal and informal institutional obstacles to effective business operations (%)

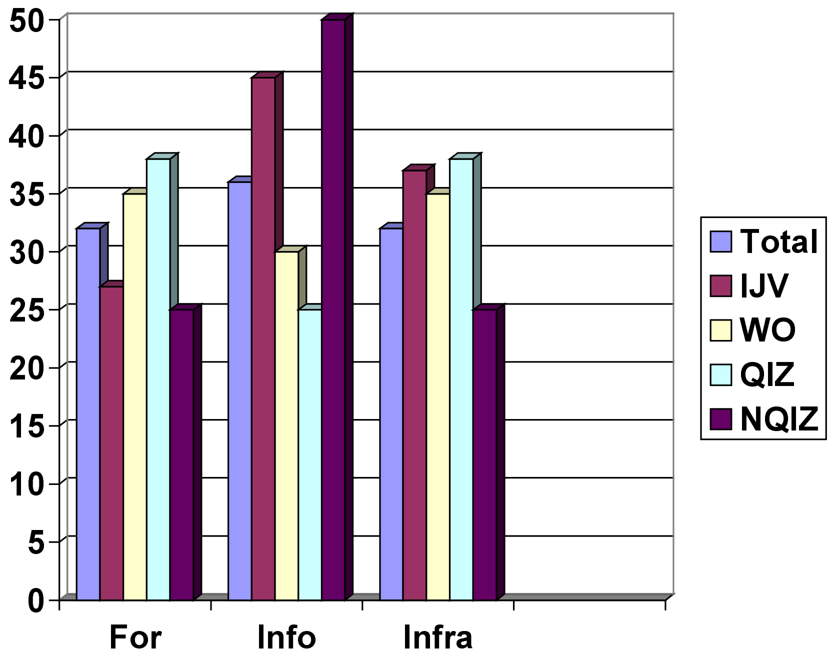
Infrastructure Obstacles	Significant problems #	Top ranked obstacle *
Skilled workers	68 (1=)	50 (1)
Logistical systems	61 (5)	14 (6=)
Small economy	30 (12=)	14 (6=)
Water supply	32 (10=)	4 (10=)
Roads and transport	20 (16)	4 (10=)
Marketing systems	18 (17)	-
Electricity supply	14 (18)	-
Telecoms systems	11 (.19)	-

Formal Obstacles	Significant problems #	Top ranked obstacle *
Govt Admin systems	64 (3=)	32 (2)
Investment incentives	64 (3=)	28 (3=)
Pace of reforms	50 (7)	8 (8=)
Clarity of rules	39 (9)	4 (10=)
Taxation system	32 (10=)	14 (6=)
Legal system	30 (12=)	8 (8=)

Informal Obstacles	Significant problems #	Top ranked obstacle *
Attitudes of bureaucrats	68 (1=)	28 (3=)
Tribal mentality	53 (6)	18 (5)
Wasta	46 (8)	14 (6=)
Inshalla	28 (14)	10 (7)
Corruption	22 (15)	4 (10=)

% of firms that rank obstacle as a significant problem (in the top three obstacles)
* % of firms that place obstacle as the most important problem
( ) ranking of obstacle

Figure 2: Percentage of Firms with First Ranking Formal, Informal and Infrastructure Obstacles



The highest top ranking was recorded for informal institutional obstacles for IJVs (45%) and for firms not located in QIZs (50%). The next top ranked obstacles were formal and infrastructure obstacles for firms in QIZs (37.5%). Infrastructure obstacles were the top ranked problem for 36% of IJVs.

The discussions with the interviewees, facilitated by the semi-structured nature of the interviews, revealed that in IJVs the foreign partner regarded the main contribution of the Jordanian partner as the ability to relate to government agencies and the domestic business community. Most of the wholly owned subsidiaries used Jordanian law firms or other types of intermediaries to handle their relationships with government agencies and the business community. All of the firms not in QIZs, that were IJVs, reported that they would prefer to operate with wholly owned subsidiaries, but that the institutional system in Jordan made joint ventures a better option.

The main problems with infrastructure were costly and inefficient logistical systems and difficulties with labour skills. The major issue with labour skills was finding workers with the appropriate technical knowledge. However, firms also reported difficulties in securing labour that could work effectively with other workers who were considered lower down the social (tribal) ladder. In the case of formal institutional factors, the major problems related to dealing with government agencies and the pace of reform were that it took a long time to get things done and it was difficult to process issues involving new procedures. The problems associated with investment incentives were that they were considered too low by those firms not in QIZs. In the area of informal institutional obstacles, the attitude of bureaucrats, Wasta and the tribal mentality were reported to lead to long delays in making decisions and difficulties in locating the correct decision makers. Those firms in IJVs found it difficult to deal with their Jordanian partners because of the time consuming and elaborate procedures associated with obtaining approval from government agencies, or with making everyday business decisions. The wholly owned subsidiaries that used Jordanian law firms, or other types of intermediaries, accepted the need for such help as a necessary, but unwelcome, cost of doing business in Jordan.

9. Discussion

The findings of the study provide support for the view that both formal and informal institutional constraints lead to significant obstacles for foreign investors. Although infrastructure obstacles do present problems, these were mainly due to a lack of skilled labour and poor logistical systems. In the case of skilled labour, at least part of the problem could be attributed to an informal institutional constraint, namely, the unwillingness of workers to collaborate effectively with people from different tribal backgrounds.

Institutional constraints appear to have a marked effect on the mode of entry. Using Jordanian partners to deal with formal and informal institutional constraints was reported as the main reason for the use of IJVs in those firms not located in QIZs. Some of the top-rated formal institutional constraints, for example, governmental administration systems, the pace of reforms and the clarity of rules, may be at least partly due to the way that these systems are operated. Specifically, the attitudes and norms of behaviour that prevail in the operation of formal institutional systems are perhaps the main reason for firms reporting problems with these formal institutional factors. Support of this view is found in reports from the interviewees that the main problem with these formal institutional factors was the time and effort needed to deal with government agencies and to conduct standard business transactions. This implies that the real cause of these problems is informal institutional factors, such as Wasta, and the attitudes of bureaucrats. Although the interviewer sought to separate these factors, it is possible that the interviewees did not appreciate the subtleties of these distinctions. This problem highlights the difficulties of researching the effects of intangible factors, such as attitudes and norms of behaviour, when investigating institutional failings. This implication of the results of the study provides support for the conclusions of some quantitative studies indicating that a clearer understanding of the interaction between formal and informal institutional constraints is important to identify the nature of the obstacles that affect foreign investors in DTCs (Abed and Davoodi, 2000; Wei, 2000).

This study also supports the view that corruption is not the most serious institutional failing (Wei, 2000). In Jordan, corruption was not among the most significant problems. The relatively low significance attributed to obstacles from the legal and taxation systems also indicates that much of the literature may be focused on issues that are less important than matters such as attitudes to formal institutional systems and the persistence of tribal or guild-like behaviour in business transactions. Alternatively, Jordan may be different from other DTCs where problems with legal and taxation systems are deemed to be very significant problems (UNCTAD, 1995; Goberman and Shaprio, 1999). It is also possible that the focus on corruption, legal and taxation systems stems from the availability of quantitative data on these factors that permits the use of statistical techniques of analysis.

The challenge is to investigate the nature of intangible factors, such as attitudes to formal institutional systems, and then to seek methods of measuring these variables to permit the application of robust quantitative techniques. These issues should be investigated in societies with similar institutional systems as Jordan, for example, Middle Eastern and North African countries such as Egypt, Morocco and Tunisia, to see if similar results can be found. If allowance were made for the specific conditions in Jordan, for example, Wasta and tribal mentality, it would be possible to test for the impact of informal institutional constraints in many DTCs by replacing concepts such as Wasta and tribal mentality with informal institutional factors relevant to the countries being studied. Such research would help to identify the important institutional obstacles to the development in DTCs.

The high ranking attributed by IJVs in Jordan to informal institutional obstacles is a rather strange finding, given that it has been argued that the use of joint ventures in DTCs is primarily in order to deal with these informal institutional obstacles. However, the discussions with the interviewees indicated that the problem was due to the foreign partners struggling to understand and adjust to the elaborate and time consuming game that has to be played by their Jordanian partners in order to do business in Jordan. Wholly owned subsidiaries, which reported fewer problems with informal institutional obstacles, have less exposure to these problems because they subcontract the relationships with government agencies and the domestic business community to law firms and other intermediaries. This implies that a solution to this problem is either to subcontract to intermediaries or to establish IJVs where the organisational pattern of the parent company is dominant. In the latter case, the domestic partner adjusts to the organisational approach of the parent and deals with institutional constraints in ways that are understandable and acceptable to the parent (Fey and Beamish, 2001).

The case of the QIZ in Jordan demonstrates that foreign investors can be induced to set up wholly owned subsidiaries in DTCs that have significant institutional failings. However, the firms in the QIZs are only loosely connected to the Jordanian economy and the spillover benefits from these investments are likely to be small. Furthermore, removal of free access to the US market is likely to lead to divestment by most, if not all, of the firms based in the QIZs.

10. Conclusion

This paper has argued that institutional failings, particularly informal institutional obstacles, have significant effects on the mode of entry and on the contribution that FDI can make to economic development. The results from the interviews support this argument. Although infrastructure problems were identified as having an adverse impact on MNCs in Jordan, they were focused on two particular problems – lack of skilled labour and poor logistical systems. Formal and informal institutional constraints appear to be more problematic. Moreover, corruption and deficiencies in legal and taxation systems, normally identified in the literature as the major institutional failings, were not as serious as informal constraints, such as Wasta and tribal mentality. The apparent connection between, for example, the attitude of bureaucrats (an informal institutional constraint) and the clarity of rules (a formal institutional constraint), provides support for the view that a clearer understanding of institutional failings requires closer study and investigation of the links between formal and informal institutional factors.

Further research is needed to develop the work carried out in this study. A closer investigation of the nature of IJVs is necessary in order to investigate the role of domestic partners and to assess the importance of different types of IJVs. For example, the impact of majority and minority share holdings, and the importance of whether the IJV is the result of privatisation, acquisition or greenfield investment.

Comparative studies would also be valuable in order to determine whether common patterns are evident across different DTCs. Other Middle Eastern and North African countries may have similar informal institutional obstacles to those in Jordan. However, it is likely that many DTCs have similar problems with formal and informal institutional constraints, but it is possible that the nature of the intangible institutional constraints are not the same as those that prevail in Jordan, and perhaps in other Middle Eastern and North African countries. Studies identifying the relevant informal institutional factors, such as Wasta, tribal attitudes and the other such intangible factors, in other DTCs would help to identify important institutional obstacles to reaping better benefits from DFI inflows. This would most likely be an improvement on studies that maintain orthodox views on these matters and only look for problems with corruption, administrative malfunction and arbitrary taxation and regulatory frameworks.

Clearer identification and measurement of the formal and informal institutional constraints is also necessary to permit the application of robust quantitative techniques assessing the relative importance of the various factors and their links to FDI inflows. This will require detailed work in order to clarify the nature of the obstacles, and to find workable methods to measure the intangible factors. Furthermore, given that the types of informal (and intangible) institutional constraints vary across DTCs, it will be important to find ways of making the results comparable, so that it will be possible to identify the relative importance of the different types of informal institutional constraints. It is possible for quantitative data on issues such as corruption, administrative malfunction, taxation data and other orthodox measures of institutional failure to provide good proxies for the type of intangible informal factors discussed in this paper. If this can be established by careful consideration of the nature of these intangible factors in DTCs, the problem of conducting comparable studies across different DTCs would be greatly reduced.

Such research would help to develop policies enabling DTCs overcome institutional failings that hamper beneficial DFI inflows. However, the importance of informal institutional factors indicates that the necessary reforms will be difficult to implement in DTCs with no history of developing institutional systems conducive to low transaction costs and with high levels of adaptive efficiency. It may take a long time for some DTCs to escape the dead hand of history that has bequeathed to them informal institutional systems that are very resistant to change.

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