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CORRUPTION, COUNTRY GOVERNANCE AND FIRMS' ENTRY MODE: EVIDENCE FROM INDONESIA

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ABSTRACT

Globalization and foreign direct investment (FDI) have made host country corruption a critical consideration for firms expanding internationally. This study investigates how perceived host country corruption influences the market entry mode choices of 207 Indonesian firms across 25 host countries between 2012-2022. Utilizing logistic regression analysis and grounded in transaction cost theory, we examine the likelihood of firms selecting joint ventures (JV) over wholly owned subsidiaries (WOS) in response to corruption risk. Results indicate that higher levels of perceived corruption in the host country significantly increase the probability of firms opting for JVs as a risk mitigation strategy. While strong country governance is often assumed to deter corruption, our findings suggest that it may not significantly reduce the perceived risk for firms entering foreign markets. This has important implications for policymakers seeking to attract foreign investment and for businesses developing strategies to navigate corrupt environments.

KEYWORDS *Corruption, Country Governance, Entry Mode, Joint Venture, Wholly Owned Subsidiary*

INTRODUCTION

Globalization has transformed the competitive landscape, enabling firms to expand into international markets (Amrullah et al., 2021). The choice of market entry mode is a critical factor in the success of international operations (Wibisana, 2022). However, challenges like corruption in host countries can impede operations and undermine anti-corruption measures (Zulyadi, 2020). Thus, firms must carefully assess risks and develop adaptable strategies to navigate the complexities of the global marketplace (Chang et al., 2021).

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The Role of Corruption in Entry Mode

Transaction Cost Theory (TCT) is frequently employed to understand how corruption influences firms' strategic choices, especially market entry mode (Sartor & Beamish, 2020). Corruption, the misuse of public office for private gain, creates uncertainty in business dealings, particularly in unfamiliar markets (Heywood, 1997). This uncertainty can manifest as unexpected costs like bribes or expenses to mitigate legal and reputational risks. When entering new markets, firms face environmental uncertainty (inability to predict market dynamics) and behavioral uncertainty (unpredictable actions by partners or officials) (Widyastuti, 2018).

To address these challenges, firms develop strategies to mitigate transactional costs and corruption-related risks. In the context of Foreign Direct Investment (FDI), firms often choose between joint ventures (JV) and wholly owned subsidiaries (WOS) (Irawan, 2017). JVs involve collaboration with local partners, leveraging their expertise and networks while sharing risks and costs. WOS provides full control but exposes the firm to all risks and expenses. Both modes can help firms understand and navigate local markets while potentially lowering entry costs (Ulibarri et al., 2020). In corrupt markets, firms may prefer JVs, as they offer access to local resources and insights while spreading risks.

However, theories of corruption offer contrasting views. The "greasing the wheels" theory suggests corruption can streamline bureaucracy and expedite transactions, especially in less efficient regulatory environments. Conversely, the "sanding the wheels" theory argues corruption creates obstacles and uncertainty, hindering efficiency and increasing risks (McGrath & Whitty, 2015). Firms from developed countries often avoid corruption due to reputational and legal concerns, while those from developing or emerging countries, more accustomed to such practices, may view it as a pragmatic way to overcome market entry barriers. Indonesia's New Order era exemplifies "greasing the wheels," where corruption aided manufacturing sector growth (Abdul Wahab et al., 2017).

Corruption is a significant obstacle to economic and political development, especially in developing and emerging countries (Liang et al., 2016). It influences investment decisions, with firms from developed countries often perceived as better equipped to navigate corruption than those from emerging economies. Research on corruption's impact on expansion has mainly focused on firms from developed countries . However, cases like Indofood's success in Nigeria highlight the potential of firms from emerging economies to compete globally (Sibarani & Lusmeida, 2021).

Understanding corruption dynamics for emerging economy firms is crucial. These firms may face unique challenges and employ different strategies compared to those from developed countries. They might rely on local networks to overcome bureaucratic hurdles, exhibit greater flexibility in navigating uncertainties, and perhaps even view corruption as a tool to facilitate operations in certain contexts.

Therefore, a key question arises: *How does perceived corruption in a country affect FDI entry mode choices for firms from emerging economies?* This question is grounded in the idea that corruption can act as a lubricant in emerging countries, potentially leading firms like those from Indonesia to favor JVs when entering highly corrupt markets. This aligns with transaction cost theory, which suggests firms prefer risk-sharing mechanisms to mitigate unforeseen costs (Purbawangsa et al., 2020).

The Role of Host Country's Governance

In the Indonesian context, the government's strong commitment to combating corruption in the post-New Order era is evident in the establishment of the Corruption Eradication Commission (KPK). This commitment aims to foster transparency and eradicate corrupt practices. Research by Aidt et al. (2008) confirms that the impact of corruption, whether seen as a lubricant or a hindrance, depends significantly on the quality of governance.

While bribery may expedite bureaucratic processes, it can also create conflicts of interest and compromise decision-making (Gneezy et al., 2019). Therefore, countries seeking to attract foreign direct investment (FDI) must establish robust governance frameworks that effectively combat corruption and instill confidence in foreign investors (Zhang, 2018). Previous research highlights that countries with weak governance are more prone to corruption than those with strong governance systems (Giachetti et al., 2019).

The Institutional Based View (IBV) provides a framework for understanding how formal and informal institutions shape individual and organizational behavior. Formal institutions, such as laws and regulations, have a regulatory function, while informal institutions, like social norms and ethics, provide a normative framework.

Through the IBV lens, governance, as a formal institution, is expected to play a crucial role in how corruption influences corporate strategic decisions. Weak governance, characterized by instability and corruption, creates a turbulent and risky business environment, marked by unpredictable policy changes and weak legal protections, deterring firms from investing in such countries (Chang et al., 2014). However, suggests that excessive regulation can also create opportunities for corruption. This raises the question: *Can strong country governance mitigate the impact of corruption on firms' entry mode choices?*

This research offers several contributions. First, it explores how firms from emerging economies navigate corruption risks and opportunities, providing insights for policymakers and businesses. Understanding the unique context of emerging countries can help stakeholders address global challenges and leverage existing opportunities. Moreover, this study fills a gap in previous testing the applicability of existing theories in the Indonesian context.

Additionally, this research emphasizes the importance of host country governance in creating a transparent and accountable business environment. A deeper understanding of the relationship between corruption and firms' global strategies can strengthen anti-corruption programs and promote business integrity worldwide.

The structure of this research ensures a comprehensive explanation of all relevant aspects. The following sections will detail the methodology, research findings, and conclusions, with recommendations for future business practices and policies. This research aims to contribute both theoretically and practically, potentially influencing business policies and practices in a positive way.

RESEARCH METHOD

The sample used in this research includes 207 subsidiary entities of Indonesian firms established during the years 2012-2022 across 25 host countries. The dataset was obtained from the Eikon Database and Financial Reports accessible through the Indonesia Stock Exchange. To provide a comprehensive overview, Figure 1 shows the framework employed in this study.

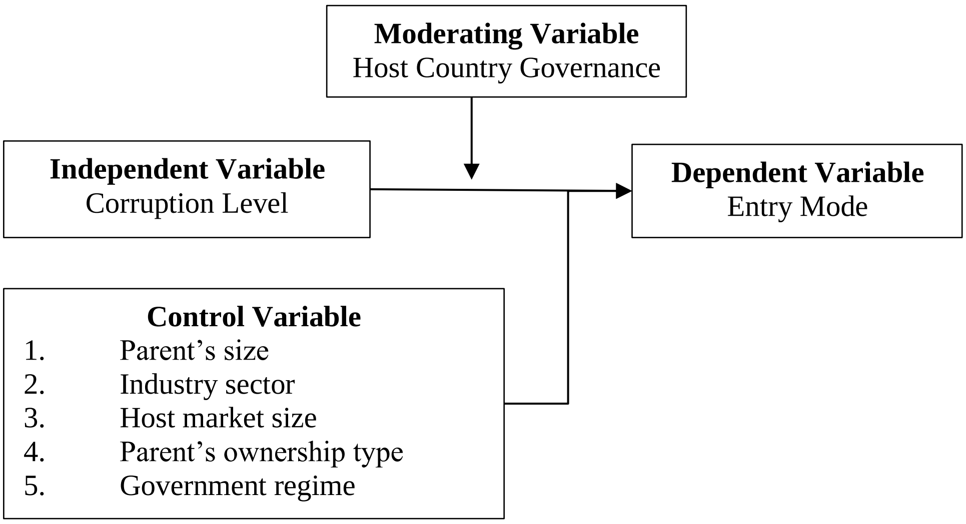

Figure 1. Research Framework
Source: Data processed by authors (2024)

Research Model

This research employs two binary logistic regression models to examine the hypotheses as follows:

H1: When entering a host country with a high level of corruption, firms tend to form JV rather than WOS.

To test this hypothesis, the following Model 1 is employed:

$$\text{logit (ENTRY)} = \beta_0 + \beta_1\text{CORR} + \beta_2\text{logMRKT} + \beta_3\text{logSIZE} + \beta_4\text{SECT} + \beta_5\text{TYPE} + \beta_6\text{REGM} + \quad (1)$$

H2: The higher the governance of the host country, the weaker the impact of the corruption level on propensity of a firm to enter via the formation of a JV.

To test this hypothesis, the following Model 2 is employed:

$$\text{logit (ENTRY)} = \beta_0 + \beta_1\text{CORR} + \beta_2\text{CGOV} + \beta_3(\text{CORR}\times\text{CGOV}) + \beta_4\text{logMRKT} + \beta_5\text{logSIZE} + \beta_6\text{SECT} + \beta_7\text{TYPE} + \beta_8\text{REGM} + \varepsilon \quad (2)$$

Variables

The corruption level variable (CORR) utilizes the Corruption Perception Index (CPI), a composite measure of perceived corruption ranging from 0 (high) to 100 (low), based on surveys and assessments from various sources. This widely used index is rescaled from 0 (no corruption) to 1 (high corruption) for easier interpretation in this. Entry mode (ENTRY) is assessed using a binary approach: wholly owned subsidiaries (WOS) are coded as 0, and joint ventures (JV) as 1.

The moderating variable, country governance (CGOV), is measured using the World Governance Indicators (WGI) score (Aidt et al., 2008; Chang et al., 2014; P. G. Méon & Sekkat, 2005). This index, ranging from -2.5 to +2.5, aggregates various sources to assess governance quality (Kaufmann & Kraay, 2022). For this study, WGI scores are rescaled from 0 (low governance) to 1 (high governance). CGOV is calculated by averaging the five WGI dimensions: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, and Rule of Law.

Control variables include parent company size (SIZE), subsidiary industry sector (SECT), and host country market size (MRKT). Given the sample size of 207 entities, these variables balance model complexity and data comprehensiveness. Parent company size, categorized as small, medium, or large, influences entry mode choice and is measured by employee count. Industry sector plays a role, with service firms often choosing WOS due to behavioral uncertainty, while manufacturing firms may prefer JVs due to environmental uncertaint. Subsidiaries are coded as 0 (service) or 1 (manufacturing). Host country market size, measured by total GDP, is a significant factor, as larger markets offer greater opportunities for strategic and operational gains. Additional controls include parent company ownership type (TYPE), coded as 0 (non-public) or 1 (public), and government regime year (REGM), distinguishing between 2015-2022 (0) and 2012-2014 (1) to account for potential governance differences.

RESULT AND DISCUSSION

Table 1 provides descriptive statistics for the variables in our study, while Table 2 presents the Pearson correlation matrix results after centering to address potential multicollinearity between CGOV and CORR. Table 3 displays the logistic regression results for Model 1, Model 2, and additional robustness tests (Models 3-4). With all Variance Inflation Factor (VIF) scores below 10 and no correlations exceeding 0.8-0.9, we confirm that multicollinearity is not a concern in our analysis.

The regression findings from Model 1 (Table 3) reveal that both the CORR (corruption level) and SECT (industry sector) variables are highly significant ($p < 0.01$). This supports our first hypothesis, indicating that higher corruption levels in a host country increase the likelihood of firms opting for joint ventures (JVs) over wholly owned subsidiaries (WOS). The positive coefficient for CORR ($\beta = 2.09$) aligns with this hypothesis.

To test our second hypothesis regarding the moderating effect of CGOV (country governance) on the CORR-ENTRY relationship, we examine the interaction coefficient CORR×CGOV in Model 2. However, this interaction term is not statistically significant ($p > 0.05$), suggesting insufficient evidence to support Hypothesis 2. Additionally, CGOV itself does not significantly influence ENTRY ($p > 0.05$). Notably, CORR remains significant ($p < 0.01$) in Model 2, further confirming Hypothesis 1. The SECT variable also remains significant ($\beta = 1.11$, $p < 0.01$).

Robustness Test

We conducted robustness tests by replacing the CORR variable with the Control of Corruption (CC) variable from the WGI index in Models 3 and 4. The results consistently support Hypothesis 1, aligning with Model 1 in terms of coefficient sign and the significance of corruption on entry mode choice. This reaffirms the robustness of our findings regarding the positive relationship between perceived corruption and the likelihood of JV entry for firms from emerging economies. It suggests that the choice of corruption measure does not significantly alter the observed effect.

Table 1. Descriptive Statistics

Var	Mean	Med.	Stdv.
Dependent Variable			
ENTRY	0.32	0.00	0.47
Independent Variable			
CORR	0.32	0.17	0.20
Control Variable			
log MRKT	11.59	11.54	0.59
Var	**Mean**	**Med.**	**Stdv.**
log SIZE	3.58	3.63	0.71
SECT	0.20	0.00	0.40
TYPE	0.92	1.00	0.26
REGM	0.31	0.00	0.46
Moderating Variable			
CGOV	0.68	0.78	0.16

Source: Data processed by authors (2024)

	ENTRY	CORR	MRKT	SIZE	SECT	TYPE	REG	CGOV
ENTRY	1							
CORR	0.164	1						
MRKT	-0.018	-0.015	1					
SIZE	-0.032	0.189	0.039	1				
SECT	0.225	0.166	0.038	0.027	1			
TYPE	-0.067	-0.012	-0.066	-0.281	-0.209	1		
REGM	-0.030	-0.059	-0.300	-0.075	0.167	0.001	1	

CGOV	-0.112	-0.466	0.128	-0.079	-0.071	-0.029	-0.034	1

Table 2. Correlation Analysis

Source: Data processed by authors (2024)

Table 3. Result of Logistic Regression Analysis

	Model 1	**Model 2**	**Robustness Test**	
			Model 3	**Model 4**
(Intercept)	-0,04(3,06)	0,37(3,1)	0,24(3,04)	0,82(3,10)
CORR	2,09(0,78)***	2,95(1,26)***		
CC			2,06(0,75)***	3,03(1,21)***
CGOV		-0,71(1,81)		-0,54(1,61)
SECT	1,06(0,38)***	1,11(0,39)***	1,05(0,38)***	1,11(0,39)***
SIZE	-0,44(0,24)**	-0,45(0,24)**	-0,45(0,24)**	-0,45(0,24)**
TYPE	-0,57(0,61)	-0,60(0,61)	-0,60(0,61)	-0,63(0,61)
MRKT	0,05(0,26)	0,00(0,26)	0,04(0,25)	-0,01(0,26)
REGM	-0,37(0,35)	-0,38(0,35)	-0,37(0,35)	-0,40(0,36)
CORR×CGOV		3,09(3,78)		
CC×CGOV				3,44(3,62)
VIF Range	1.07-1.24	1.07-8.96	1.06-1.25	1.08-6.87
$\overline{VIF}$	1.14	3.05	1.14	2.90
AIC	256.09	259.20	255.68	258.45

**p<0.05; ***p<0.01
Source: Data processed by authors (2024)

Discussion

Corruption's impact on the economy, particularly within the context of FDI, is complex. The "greasing the wheels" theory proposes that corruption can streamline business processes by reducing bureaucratic obstacles. However, this perspective is controversial as it may perpetuate inequity and legal ambiguity. In contrast, the "sanding the wheels" theory posits that corruption increases costs and risks for firms. Aligned with transaction cost theory, high corruption and weak governance elevate costs due to uncertain risks, pushing companies to adopt specific market entry strategies to mitigate these risks. This raises critical questions: *Can a country's corruption level influence the entry mode chosen by emerging market companies? Can strong state governance diminish corruption's impact on firms' entry mode choices?*

Our study contributes in several ways. First, it investigates how firms from emerging economies manage corruption-related risks and opportunities, offering insights for policymakers and practitioners to develop effective strategies. By understanding the unique context of emerging countries, stakeholders can better address global challenges and capitalize on existing opportunities. This research also fills a gap in prior literature by extending existing theories to the Indonesian context. Our findings align with previous research, showing that Indonesian firms tend to favor joint ventures (JVs) when entering highly corrupt markets. JVs enable risk and cost-sharing by leveraging partners' market knowledge and networks to navigate uncertainties. However, potential partners may not adhere to anti-corruption standards, creating additional challenges. Thus, firms must tailor anti-corruption efforts to local contexts and adapt to changing environments.

While JVs can be advantageous, they do not guarantee smooth market entry. As highlight, managerial decisions are crucial for JV success. Thorough evaluations are essential to ensure alignment with strategic goals and partner commitment to sharing resources. Transparent objectives from the outset foster mutual understanding and aligned interests, while clear performance metrics help prevent conflicts.

Furthermore, our research examines the role of country governance in moderating corruption's influence on entry mode choices. Contrary to expectations, we find that strong governance does not significantly mitigate the impact of corruption on the likelihood of JV formation nor directly influence the choice between JVs and wholly owned subsidiaries. This contrasts with Chang et al. (2014), who suggested that high host country governance encourages wholly owned subsidiary entry. While not statistically significant, our results do not definitively reject the initial hypothesis regarding governance's role. Further investigation is warranted, considering factors like the dominant influence of corruption levels (found significant in our model) on entry mode choices. The relationship between governance and entry mode may be more complex than assumed, with potential unidentified variables at play. Future research should explore these factors to fully understand the role of country governance in firms' expansion decisions.

Notably, reveal a correlation between increased regulation and more corruption opportunities, as regulations can facilitate bribes related to policies, subsidies, and contracts. Therefore, designing effective regulations requires prioritizing transparency and resilience against corrupt practices. Kaufmann et al. (2011) advocate for a holistic approach, emphasizing that governance effectiveness depends on both formal regulations and informal institutions that shape the exercise of authority. Combining formal and informal governance is crucial to uphold societal norms while incorporating local traditions and ethics in policymaking.

CONCLUSION

This study provides crucial insights into how corruption and country governance shape firms' global strategies. Employing Transaction Cost Theory (TCT) and the Institutional Based View (IBV), we confirm that corruption increases the likelihood of firms from emerging economies choosing joint ventures (JVs) over wholly owned subsidiaries (WOS) as a risk adaptation mechanism. However, a key finding is the insignificant influence of country governance in mitigating corruption's impact on entry mode decisions. This result deviates from prior research and suggests potential variations in governance perceptions within countries.

The insignificant role of country governance in moderating the effect of corruption on entry mode choices warrants further investigation. Future research could examine this relationship in a broader sample of countries, comparing developed and developing nations to understand potential variations in governance perceptions. Additionally, given the significant and consistent influence of firm sector, consistent with previous findings, future studies could delve deeper into the relationship between firm sector and entry mode choice.

Our study also highlights the need for collaborative efforts among governments, anti-corruption bodies, the private sector, and civil society to enhance transparency and implement regulations that minimize opportunities for corruption. Such initiatives are crucial for fostering a more favorable business climate and reducing corruption-related barriers. Furthermore, firms, particularly those from developing economies, can benefit from adopting adaptive and flexible strategies and leveraging local networks in host countries to thrive in the global market.

This study has some limitations. First, it focuses on Indonesian firms, and the results may not be generalizable to firms from other countries with different cultural, economic, and political characteristics. Second, we focus on corruption and governance as determinants of entry mode choice, but other factors like firm size, international experience, industry characteristics, and specific market factors in the host country can also influence this decision. Third, we rely on secondary data, which may not always be fully accurate or complete. Future research could collect primary data through surveys or interviews for more detailed and accurate information. Fourth, our quantitative approach may not capture the complexity of qualitative factors influencing entry mode decisions. Qualitative methods like interviews or case studies could provide deeper insights into firms' decision-making processes.

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