Partner Search by Multinational Corporations in a Corrupt Environment – Evidence from Indonesia

Ahmed Mushfiq Mobarak[1]; Denni Purbasari[2]; Lukas Fesser[3]
[1]Yale University, [2] University of Colorado at Boulder, [3]Yale-NUS College

Abstract

This project seeks to examine the importance of political connections for a company to be chosen as a local partner in a joint venture. We investigate local partner choice by MNCs operating in Indonesia under the Suharto regime between 1990 and 1997.

We estimate the importance placed on political connections relative to other firm characteristics, such as market share or profitability and find that firms connected to Suharto are 22 to 37 percentage points more likely to be selected as local partners in a joint venture when compared to local non-connected firms. We take this as strong evidence that in corrupt environments, political connections might have a larger impact on MNC decisions than firm fundamentals.

Introduction

Only a small subset of economic literature on Foreign Direct Investments focuses on how Multi-National Corporations react to corrupt environments in host countries[1,2]. Corruption is often so widespread in developing countries that MNCs often have to adapt to this environment in clever ways in order to survive. In this project, we develop systematic empirical evidence on one important form of adaptation and ask:

In joint venture schemes, are MNCs more likely to choose local partners that are politically connected to the host country government? What economic considerations govern this partner choice, and how valuable are political connections relative to these other considerations?

Methods and Materials

For our empirical analysis on the relationship between political connections and joint venture cooperation, we

- Identify all MNCs that set up joint venture in Indonesia during 1990-1997
- Identify the chosen local partner and plausible sets of potential partners
- Identify politically connected firms

Between 1990 and 1997, 78% of MNCs that entered Indonesia entered through joint venture schemes. We define joint ventures to be cases where the local firms had a non-zero ownership share in the project. The *Annual Survey of Manufacturing Firms*[4] provides us with characteristics of local partners, such as outputs, profits, exports, ownership etc. We then identify potential partners as firms that share similar characteristics as the partners chosen. We restrict our definition of politically connected firms to only those that are directly owned or managed by a Suharto family member.

Comparison between Connected Partners vs. Non-Connected Partners

Variable	Firms Chosen as MNC Partner: Connected Firms (28 obs.) Mean (Std. Dev.)	Connected Firms (28 obs.) Range	Non-Connected Firms (168 obs.) Mean (Std. Dev.)	Non-Connected Firms (168 obs.) Range
Firm Market Share: Firm Output divided by Industry Output	0.092 (0.197)	(0-0.89)	0.035 (0.071)	(0-0.35)
Value of Firm Production in trillion Rupiah	0.332 (0.899)	(0-4.11)	0.118 (0.416)	(0-2.78)
Number of Workers	1550.2 (2144.4)	(69-8697)	1059.4 (2584.5)	(22-14584)
Profits: Revenue minus Expenditures (in trillion Rupiah)	0.189 (0.527)	(0-2.35)	0.070 (0.278)	(-0.01-1.95)
Productivity: Total Factor Productivity (logged)	2.736 (1.025)	(1.51-5.33)	2.949 (1.338)	(0.73-7.3)
Profitability: Profits divided by Fixed Assets/100	0.042 (0.153)	(0-0.82)	0.046 (0.271)	(-0.08-3.27)
Central Government Ownership Share of Firm	0.116 (0.316)	(0-1)	0.012 (0.109)	(0-1)
Foreign Ownership Share of Firm	0.078 (0.177)	(0-0.5)	0.306 (0.371)	(0-1)
Fraction of Production that is Exported	0.076 (0.185)	(0-0.84)	0.309 (0.405)	(0-1)

Table 1. Firm characteristics of local companies. Standard deviation in parentheses.

Results

We find that the production of chosen firms is almost nine times bigger than the average non-chosen firms and the number of workers is almost six times larger. Consequently, their market share is also almost four times larger. Chosen firms also tend to be more export oriented and to have larger shares of foreign ownership.

We also find that firms connected to Suharto are between 22 and 37 percentage points more likely to be chosen as a local partner in a joint venture compared to non-connected firms. Although only 1.1% of firms in the sample are politically connected, such firms are chosen as partners about 34% of the time.

Further, the likelihood that MNCs choose a connected local partner increases with the value of investment. The preference for connected partners is more pronounced when the MNCs hold the majority stake in the subsidiary. The evidence that MNCs are more likely to choose connected partners is robust across different MNC assets, sales, and country of origin.

Conditional Logit Estimation of the Likelihood that the Firm is chosen as Partner (Dependent Variable: Firm is chosen as MNC Partner in a Joint-Venture)

Variables	(1)	(2)	(3)
	All Firms		
	Firms in the Same ISIC4	Firms in the Same ISIC4 and Location	Firms in the Same ISIC4, Location and Size
Firm is Politically Connected based on its Relationship with Suharto Family or Stock Exchange Regressions (Indicator)	0.220*** (7.46)	0.344*** (5.74)	0.277** (2.36)
Value of Firm Production in trillion Rupiah	-0.002 (1.17)	-0.011* (1.71)	
Profits: Revenue minus Expenditures (in trillion Rupiah)	0.002** (2.30)	0.009* (1.93)	0.010 (0.70)
Number of Workers	0.020*** (8.99)	0.047*** (5.51)	0.033 (0.39)
Firm Market Share: Firm Output divided by Industry Output	0.002 (1.21)	0.007** (1.99)	
Total Factor Productivity (logged)	-0.021 (0.18)	0.125 (0.64)	-0.438 (0.72)
Profitability: Profits divided by Fixed Assets/100	-0.006 (0.89)	-0.015 (1.46)	-0.010 (0.60)
Central Government Ownership Share of Firm	-0.0002 (0.07)	0.0003 (0.08)	-0.003 (0.23)
Foreign Ownership Share of Firm	0.018*** (6.55)	0.026*** (4.21)	0.031 (1.28)
Fraction of Production that is Exported	0.039*** (5.42)	0.060*** (4.97)	0.082* (1.75)

Table 2. Robust z statistics in parentheses; * significant at 10%, ** significant at 5%, *** significant at 1%. Marginal effects and elasticities are reported. Marginal effects measure a discrete change of an indicator variable from 0 to 1.

Discussion

Our findings strongly suggest that political connections outweigh firm fundamentals as a basis in MNC decision: Even foreign firms, who are presumably untainted by Indonesian politics, value firms with connections to Suharto.

Finally, we also find some suggestive evidence that such strategic choice benefits MNCs but might reduce overall welfare. Unfortunately, the empirical evidence on such costs is constraint by the data available.

Conclusions

This project has demonstrated that partnership with connected firms is beneficial. This result is important in itself because it sheds light on the nature of MNC adaptation, or the precise channel through which corruption may affect MNC decision in corrupt emerging countries. We would now like to encourage future research to dig deeper and ask whether such a choice imposes a cost for the MNC and a welfare cost on Indonesian society as a whole as suggested by our findings.

Contact

Lukas Fesser
Yale-NUS College
Email: Lukas.Fesser@u.yale-nus.edu.sg
Website: https://economics.yale.edu/people/lukas-fesser
Phone: (+49) 15735181833

References

- [1] Delios, Andrew and Witold J. Henisz (2003). "Policy Uncertainty and the Sequence of Entry by Japanese Firms 1980-1998." Journal of International Business Studies, 34: 227-241.
- [2] Henisz, Witold (2000). "The Institutional Environment for Multinational Investment." Journal of Law, Economics, & Organization, 16(2): 334-364.
- [3] Mobarak, Ahmed Mushfiq and Denni Purbasari (2005). "Political Trade Protection in Developing Countries: Firm Level Evidence from Indonesia."
- [4] Statistics Indonesia (1998). Manufacturing Establishments Directory. Jakarta.
- [5]World Economic Forum (1999). The Global Competitiveness Report 1999. Oxford University Press.