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Abstract

Using the data from World Business Environment Survey (WBES) on over 10,000 firms across eighty one countries, this paper finds preliminary evidence that foreign firms enjoy significant regulatory advantages—as perceived by the firms themselves—over domestic firms. The findings on regulatory advantages of foreign firms hold with a variety of alternative measures of regulations and with or without firm- and country-level attributes and industry and country controls. There is also evidence that foreign firms' regulatory advantages are especially substantial vis-à-vis the politically weak domestic firms. Furthermore, the regulatory advantages of foreign firms appear stronger in corrupt countries than in non-corrupt countries.

Are Foreign Firms Privileged by their Host Governments? Evidence from the 2000 World Business Environment Survey

In his seminal book, The Other Path: The Invisible Revolution in the Third World, Hernando de Soto documented the extremely difficult regulatory environment facing small businesses in Peru. In a real social science experiment, de Soto assembled a research team and instructed the team to follow all the required bureaucratic procedures in setting up a one-employee garment factory. The process took the team members 289 days and cost them $1,231 altogether, an equivalent of three years in average Peruvian wage (De Soto 1989).

De Soto's social science experiment was conducted in 1983 and we should note the broad policy context of his accounts of the business on the ground at the time. The early 1980s in Peru, in fact, coincided with a move away from the state-led development strategy Peru adopted since 1968. As a number of Latin American specialists noted, the administration of Fernando Belaunde (1980-1985) undertook a privatization program, promoted primary exports and, above all, aggressively pursued foreign direct investment (FDI) by conferring substantial tax and other benefits on foreign firms (Pastor and Wise 1992; Wise 1994). This paper will show that this juxtaposition of regulatory constraints imposed on domestic firms on the one hand with an active FDI promotion stance on the other is by no means limited to Peru in the 1980s.

The other dynamic de Soto noted in his book also runs through this paper. The kind of regulatory constraints documented in The Other Path did not fall on all domestic firms in Peru but fell disproportionately on the small and politically powerless domestic firms. In fact, the cumbersome regulatory procedures and requirements benefited the small group of political and economic elites, who could circumvent these constraints easily with their political power and connections. One could argue further, as (Shleifer 1993) did, that these complicated regulations were instituted so that bureaucrats could solicit bribes. This paper looks at the effect on the regulatory environment facing foreign firms in the presence of a political bifurcation of domestic firms and in the presence of corruption.

In the FDI research, there is a long and venerable view that host governments discriminate against foreign firms in order to protect domestic firms.[1] This is known as the "national preference" view of the world.[2] Despite the prominence of the national preference claim, few have actually examined this claim

[1] We focus on governments in their host capacities. Foreign firms here refer to the resident subsidiaries or affiliates established via FDI and by firms located outside the host countries. By this definition, purely importing foreign firms are excluded; so are financial foreign firms that have invested in stocks overseas.

[2] The phrase, "national preference," belongs to (Caves 1996).

empirically. In this paper, we first identify a number of empirical and conceptual shortcomings with the national preference claim and then we will provide evidence to support an opposite claim—that host governments often privilege foreign firms at the expense of domestic firms, especially politically-weak domestic firms. We call the alternative to the national preference claim "foreign privilege" claim in this paper.

As far as this author is aware, this is the first paper that examines the national preference claim empirically on the basis of cross-country evidence.[3] A number of detailed regional studies—of Latin America, China and Malaysia—have uncovered and offered valuable insights about the foreign privilege phenomenon (summarized in the appendix to this paper), but these insights have not been generalized to other countries.[4]

The data used in this paper come from World Business Environment Surveys (WBES), implemented between 1999 and 2000 in eighty-one countries and on more than 10,000 firms operating in these countries. Based on an analysis of the survey data, this paper makes—and provides evidence for—three claims. First, there is strong and consistent evidence that there are substantial regulatory advantages to being a foreign firm operating in these eighty-one economies as compared with an average domestically-owned firm. The regulatory advantages here refer to subjectively-rated less severe constraints across nine regulatory areas faced by foreign firms as compared with those facing domestic firms. Second, these regulatory advantages enjoyed by foreign firms are only present when the foreign firms are benchmarked against politically powerless domestic firms and are otherwise absent when benchmarked against politically connected domestic firms. (In the latter case, in fact, there is some evidence for regulatory disadvantages afflicting foreign firms—i.e., foreign firms are more constrained by the regulatory environment.) Third, the regulatory advantages—in the way postulated above—are present or are stronger in corrupt countries compared with non-corrupt countries.

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[3] One paper, as far as I am aware, which does postulate a theoretical scenario of foreign privileges, provides neither empirical evidence nor a straightforward conjecture for how foreign privileges can occur. The paper describes the possibility for supranational treatment of foreign firms as an exhaustive exercise of all the theoretical possibilities facing foreign firms. Here is how (Rugman and Verbeke 1998, p. 121) explain the supranational treatment: "The reason for such preferences is that a symmetrical position of inward and outward FDI at the public policy level, and a dispersed FDI configuration at the firm level, lead to complexities in terms of optimal business-government interactions that cannot be solved at the national level."

[4] A number of World Bank researchers used WBES dataset and generated results similar to the findings reported in this paper. But their focus is not on the treatment of foreign firms. Some of their findings are summarized later in the paper.

The first part of this paper proposes a number of hypotheses about the regulatory environments jointly facing foreign and domestic firms. The second part of the paper describes the dataset and the variables. The third part presents findings adjudicating the national preference and foreign privilege claims. The fourth part concludes.

Are foreign firms privileged?

The view that host governments privilege domestic over foreign firms runs long and deep in FDI research and in general economic research. For example, in a recent paper on entry regulations, (Djankov, La Porta, Lopez-de-Silanes and Shleifer 2002) conjectured, without proof, "Foreign ownership frequently involves additional verifications and procedures." Indeed, the national preference is often treated as a building bloc of standard economic analysis of FDI. According to (Caves 1996, p. 57), "an elemental point" about why FDI does not occur all the time is because foreign firms are naturally disadvantaged operating in unfamiliar host territories. (Ethier 1986, p. 805) has a similar view, as in the following, "A particular framework of thought about foreign direct investment is now dominant. This framework suggests why multinational firms should exist at all in the face of presumed penalties for operating across national and cultural boundaries." To be sure, FDI theorists have in mind far broader advantages domestic firms are presumed to command beyond regulatory treatments, but an important reason they emphasize is that domestic firms are favored by their own "legal and social system."[5]

We show that to the extent that the national preference model has been subjected to empirical examinations previously the results often contradict the national preference view of the world. In part, inspired by some of the empirical anomalies in the national preference model, we argue for a need to reexamine this model carefully and empirically. The national preference model was invented in the 1950s and 1960s when many host governments did impose onerous restrictions on foreign firms. At the minimum, we want to know if this model still applies after two decades of FDI liberalization. There is also a conceptual case to reexamine this model. As will be shown later, the model contains a number of ambiguities when extending the model to countries beyond traditional recipients of FDI—politically and economically mature OECD countries.

National preference hypothesis

The national preference model has both empirical and theoretical progenitors. On the empirical side, in the 1950s and 1960s, many host governments, especially those in developing countries, were

[5] The broad advantages encompass domestic firms' familiarity with "ways of doing things" and the ready access to "social and cultural milieu" in their own countries. See (Caves 1996, pp. 57-58).

deeply suspicious of the negative economic and political effects of FDI and they imposed various restrictions on multinational corporations (MNCs).[6] While FDI scholars debated whether MNCs or host governments held an upper hand in their antagonistic relationships, seldom did they disagree on this "national preference" view of the world."[7] In the national preference model, as a flip side of restrictions on MNCs, host governments are generally assumed to privilege domestic firms over MNCs.

A more conceptual underpinning of the national preference claim is that politicians reap electoral benefits from re-distributing the income of MNCs.[8] The assumption is that in a democratic system, voters hold equities in various factor services but, by definition, they do not derive income flows from the foreign equities in domestic affiliates or subsidiaries. Another condition is that foreign equity holders in the local subsidiaries do not vote. In this scenario, governments favor redistributing income of MNCs over redistributing the income of purely domestic concerns because of lack of political representation of foreign equity holders (Caves 1996, p. 250).[9] This political model, while fully acknowledging the power of MNCs through other channels, such as campaign contributions and rent-seeking activities, nevertheless holds MNCs in a politically inferior position, as (Caves 1996, p. 250, fn 6) remarks, "the political

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[6] Some of the pathbreaking works in this area were by (Vernon 1971 ; Vernon 1977).

[7] On one side of this debate, (Stopford and Strange 1991) argue that MNCs control vital resources and are able to transcend the traditional authority of nation states. (Vernon 1971) and (Bergsten 1978) put forward the idea that the bargaining power of MNCs over host governments decreases over time. This is the obsolescing bargain idea. Notice neither side of this debate questions the premise that host governments and MNCs conflict with each other; they disagree over capabilities of MNCs.

[8] This line of inquiry is distinct from another political mechanism postulated in the FDI literature and this has to do with the idea that some governments restrict imports but not FDI. To the extent that FDI and imports are, to a degree, substitutes, a more nuanced research question is why governments may restrict one form of foreign competition over another form of foreign competition, not why governments shield domestic firms from all foreign competition. Many governments, in both developing and developed worlds, go to a great length to restrict imports but go to an equal or greater length to court FDI. One treatment of this topic is by (Bhagwati, Dinopoulos and Wong 1992). The notion, known as qui pro quo FDI, is that FDI in one period is designed to generate good will in the importing country in order to defuse protectionist sentiment in the subsequent periods. This line of research focuses on the motivations and behavior of the capital/goods suppliers. The question posed in this paper is about the motivations and behavior of capital recipients. Also by definition, Bhagwati's framework does not apply to many developing countries, which are non-democratic and which receive export-oriented FDI.

[9] As (Caves 1996) remarks, "[b]ecause foreigners do not vote in national elections, pure redistributions away from foreign equity holders cause no negative votes and thus should proceed further than redistributions adverse to the interests of enfranchised minorities."

influence of foreigners is sensibly regarded as discounted from that of equivalent domestic business units."

There are both empirical and conceptual reasons to revisit the national preference claim. The empirical milieu that inspired the first generation research on MNC-host government interactions—pioneered by Raymond Vernon—has changed dramatically in the 1980s and 1990s. Many governments have moved away from policies designed to extract rent and technology transfer from MNCs and have embraced a pro-FDI policy stance. FDI is now commonly viewed as an engine of growth. At least, it is worth asking whether national preference claim is still an empirically accurate description of the world in the 21st century. But even during the heyday of import substitution, it should not be axiomatic that domestic firms were privileged. This is because we may know far more about policy restrictions, asset expropriations, and regulatory hurdles involving MNCs than we do about the regulatory environment facing domestic firms. The "dislodging" of MNCs, such as what happened in India in the 1970s, is often a high-profiled affair in the media and receives diplomatic and political attention from the rich and developed FDI-source countries.[10] The treatment of domestic firms, especially those without political clout, often garners far less attention.

Another empirical issue is that governments that favor domestic firms may still court FDI. An example comes from research on business groups in Asia. Summarizing a large body of research on this topic, (Claessens, Djankov and Lang. 2000) remark: "the dominance of most business groups lies in the privileges that they solicit from the government: exclusive exporting or importing rights, protecting from foreign competition for extensive periods of time, granting of monopoly power in the local market, procurement of large government contracts, etc." It should be noted, however, that some of the countries prominently featured in Claessens et al.'s research are among the most enthusiastic champions of FDI in the world. In 1985, before FDI promotion became fashionable, the FDI stock/GDP ratio reached 28.2 percent in Indonesia, 23.3 percent in Malaysia, and 73.2 percent in Singapore. In comparison, the average ratio for developing countries was 13.9 percent and for developed countries, 6.2 percent.[11]

One reason for this compatibility between national preference and courting of MNCs is straightforward: Not all domestic firms are created equal. Governments may protect some domestic firms against foreign competition but may choose not to do so for other domestic firms. This "pick-and-

[10] For example, (Encarnation 1989) describes how American MNCs in India relied heavily on "embassy help" when negotiating with the Indian government, which was suspicious of MNCs.

[11] The data come from (United Nations Conference on Trade and Development 2002).

choose," rather than an indiscriminant, treatment of domestic firms is well documented.[12] Thus even if we can accept the general validity of the national preference claim we do not know if a sweeping version of this claim—that host governments privilege *average* domestic firms—is correct. It is at least conceivable that some governments, while imposing various constraints on domestic businesses, may court FDI by choosing to be "business-friendly" to foreign firms in the way the Peruvian government did in the 1980s. If we take it as given that regulatory treatments of domestic firms may differ, it is largely an empirical issue whether governments privilege *average* domestic firms over foreign competition. Some may do so but others may not.

There are also conceptual reasons to revisit the national preference claim. While host governments may wish to favor domestic firms, foreign capital is more mobile than domestic capital. To entice the same level of investments, a host government may have no choice but to treat foreign firms better. The political mechanism that produces the national preferences makes ambiguous predictions once we extend our inquiry to non-democratic countries and/or to poorly functioning democracies. Democracies are not the only countries that have to grapple with MNCs; some of the most authoritarian countries in the world—China now and Singapore in the 1970s and 1980s—are among the top recipients of FDI in the world. In authoritarian countries, foreign equity holders do not vote but nor do domestic equity holders. The absence of electoral benefits makes it hard to predict the income re-distribution policies—vis-à-vis MNCs—on the part of authoritarian governments. Some authoritarian governments may restrict MNCs; others may promote them. The re-distributional motivations on political grounds are *a priori* ambiguous in authoritarian countries and thus it becomes an empirical question whether national preference model explains the treatment of MNCs in authoritarian countries.

The political discount of foreigners, in the way as postulated by Caves, is implicitly based on the view that voting is the most important political currency. Voting is clearly bound by nationality but only in a perfect democracy is voting the most important political currency. There are many "illiberal democracies" in the world and in a poorly functioning and newly-emerging democracy the real venue of power revolves around lobbying by special interest groups, financial contributions or the ability to bribe

[12] (Fisman 2001), for example, provides evidence that the stock prices of Indonesian firms connected with President Suharto rose—and fell—faster than the less connected firms along with the rumors about Suharto's health. Indonesian investors well understood the value accruing to the politically-connected firms. (Johnson and Mitton 2003) show that capital controls imposed in Malaysia in 1998 benefited those Malaysian firms with close ties to the then Prime Minister Mahatir at the expense of other firms without such ties. (McMillan and Woodruff 1999), on the other hand, show the effect of credit and legal discrimination against the politically weak private firms in Vietnam.

individual politicians. [13] For the national preference model to work, one has to argue that MNCs are not only handicapped at voting booths but also in these other power corridors. At least, some empirical evidence suggests otherwise. The paper by (Hellman, Jones and Kaufmann 2002), for example, shows that corruption does deter aggregate FDI inflows but once foreign firms have entered they may engage in more corrupt practices than domestic firms. The point here is not that MNCs necessarily command a political advantage over domestic firms; rather, the point is that once we allow for the role of political mechanisms that are not bound by nationality, the question as to who has the political advantage is not straightforward. An empirical inquiry is thus called for.

Some tentative hypotheses

The appendix of the paper summarizes some case study evidence on foreign privilege. The case study evidence is culled from regional specialists' works on Latin America, China and Malaysia. Regional specialists have long noted that some governments repressed domestic capitalists/entrepreneurs while courting heavily foreign firms. The motivation is political. In Latin America in the 1970s, to push the ambitious industrialization programs, the governments favored FDI while repressing the apparently consumption-oriented domestic capitalists. In China in the 1990s, the government imported a massive amount of FDI to make up for the shortfalls in the domestic entrepreneurship and private initiatives, which the communist party suppressed to preserve controls. In Malaysia, the government used FDI to eclipse economically efficient but politically suspect ethnically Chinese.

These country case studies can at best offer stylized facts about the foreign privilege phenomenon but we do not know how generalizeable these insights are. One can easily and legitimately claim that the results are driven by the idiosyncrasies of the individual countries. The recently-available large-scale survey data (such as WBES) have enabled researchers to probe into this question on the basis of cross-country evidence. Three separate analyses of the WBES data—all by the researchers at the World Bank—show results more consistent with the foreign privilege claim than with national preference claim.[14]

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[13] On this issue, (Olson 1965) has the most valuable insights.

[14] The first paper, by Nithya Nagarajan et al. of Foreign Investment Advisory Service, shows that across ten business environment areas—financing, taxes and regulations, inflation, policy instability, anti-competitive practices, infrastructure, street crime, exchange rate, organized crime, and corruption—foreign firms are more constrained than domestic firms only in one area, infrastructure (Nagarajan 2001). These findings are based on a global sample of firms and when regressions are run on separate geographic regions the foreign privilege phenomenon is found to be stronger in Latin America and Eastern Europe than in Africa, East Asia and OECD countries. The second paper is by researchers at the World Bank who used WBES to analyze business constraints (Batra, Kaufmann and Stone 2003). One set of their regressions uses business constraints as dependent variables.

However, these three analyses simply document the differences in the business constraints faced by foreign firms and domestic firms without exploring the causes or the effects of the foreign privilege phenomenon. This is in part due to the analytical emphasis of the World Bank researchers. Two of the papers primarily aim at understanding the effects of business constraints on economic growth and investment and the impact on small and medium firms. None of the studies is designed to explore the reasons for business constraints *per se* and to explicitly test the national preference claim.[15] Nor is there any attempt to uncover the institutional determinants of the foreign privilege phenomenon.

Inspired by the insights offered by the country-case studies, I formulate three hypotheses here. First, we test a sweeping version of the national preference hypothesis—that host governments privilege *average* domestic firms over foreign firms. Specifically, the national preference hypothesis is validated if the status of being a foreign firm is consistently associated with a more severe affliction of business constraints. The foreign privilege hypothesis will be validated if the status of being a foreign firm is associated with an alleviation of business constraints. The benchmarked firms are all the domestic firms in the sample.

Our second hypothesis is that whether national preference or foreign privilege prevails may very well depend on the political status of the benchmarked domestic firms. Our example from Malaysia—summarized in the appendix— illustrates this dynamic. The government might have imposed more constraints on foreign firms in order to protect the politically-favored *bumiputra* businesses but the same government might have calculated to expose the ethnically Chinese firms to greater foreign competition.

Nine business constraint indicator variables—finance, taxes and regulations, inflation, exchange rate, corruption, tax administration, infrastructure, political instability and high taxes—were alternately regressed on a number of firm-level characteristics, such as size of firms and firms with foreign ownership. Out of the nine regressions with business constraints as dependent variables the coefficients for firms with foreign ownership are negative—i.e., negatively correlated with business constraints—in seven of them. Out of these seven coefficients five of them are statistically significant. One of the nine regressions produced a statistically significant positive foreign coefficient when the dependent variable is exchange rate. The third paper, by (Schiffer and Weder 2001), reports similar findings.

[15] In fact, the World Bank researchers seem to be reluctant to reach the conclusion that foreign firms are privileged despite their findings. In one case, the researchers report that the foreign privilege findings are weaker in regional regressions than on global regressions, which, incidentally, is the case for all other regression results on business constraints. In the other paper, after reporting that foreign firms face fewer problems than domestic firms, (Schiffer and Weder 2001, p. 35) write, “This is an interesting finding in itself since the opposite finding would have been equally possible.”

Scholars on Malaysia termed the FDI policy as an "ethnic by-pass strategy" designed to repress the ethnically Chinese firms. Regulatory treatments of foreign firms were elevated relative to the politically-repressed ethnic Chinese firms but were made inferior relative to the politically-favored *bumiputra* businesses..

Our third hypothesis is that the quality of the institutional environment can affect the biases in the regulatory treatments of firms. In a corrupt political system, the nationality-bound political mechanism—such as voting—does not exert a strong check-and-balance effect on politicians. Policies and regulations can be affected by those political mechanisms less bound by nationality such as rent-seeking and bribery. If so, there is no a priori reason why foreign firms necessarily command a political disadvantage compared with domestic firms. Another postulation is that a corrupt but developmentally-oriented government needs to become more "business friendly" to foreign firms precisely because it is desperate for capital when the high level of corruption has deterred domestic investments. Our discussion on the corruption-dependent regulatory treatment of foreign firms is linked naturally to the emerging body of research on the connections between corruption and FDI. [16]

Data and variables

World Business Environment Survey (WBES)

The World Bank designed and implemented—with the cooperation of partner institutions—the WBES in 1999-2000. The survey was designed to capture firms' views on many aspects of a business environment pertaining to their operations. This paper only focuses on one aspect of a business environment facing a firm—taxes and regulations. The findings, thus, should not be generalized across the entire spectrum of the business environment in which a firm operates (although, it should be noted, the aforementioned World Bank analysis of the WBES data shows that foreign advantages are across the board.) This topical limitation to the regulatory environment is motivated by a desire to keep our analysis tractable and by a recognition that different aspects of a business environment may very well exert different effects on a firm.

A more substantive justification for this focus is that among the eleven general business constraints in the WBES, taxes and regulations have been consistently ranked as the most severe business constraint on average. For the worldwide sample of all firms, the average score for taxes and regulations

[16] See, for example, (Hines 1995), (Wei 2000), (Henisz 2000), and (Hellman, Jones and Kaufmann 2002).

is 2.93, followed by financing (2.81) and inflation (2.8).[17] (Higher scores indicate more severe business constraints.) One reason could be that taxes and regulations are arguably the most intensive form of interface between government and business. Government and business interact with each other on issues of tax and regulation directly and on short intervals or on a continuous basis. Economic policies, inflation, and governance, on the other hand, may exert significant but possibly more episodic effects on firms mainly as background factors. The other substantive justification is that taxes and regulations fall unambiguously into the domain of government decision-making. This is distinguished from finance where government policies and the characteristics of financial institutions jointly affect a firm's access to finance.[18] Thus focusing on issues related to taxes and regulations is an efficient way to get at those aspects of a business environment most directly under control of the government.

The WBES specifies a number of targets in terms of representation of industries, size and nationality, ownership characteristics, and export status of firms for surveys across all regions. The sectoral composition of firms is roughly allocated in accordance with their contributions to GDP. However, the industry breakdowns are at an aggregated level. The firms are broken down along five broad economic sectors: manufacturing, service, agriculture, construction and a category known as "other." Of the sample, at least 15 percent are set aside for the small firms—defined as firms with fewer than 50 employees—and at least 15 percent are large firms (with more than 500 employees). At least 15 percent of the sample comprises of firms with foreign ownership and at least 15 percent of firms are to export 20 percent of their output. The realized sample differs from these targets considerably. Large firms account for 20 percent of the sample and 19 percent of the firms reported having foreign ownership.

There are several issues that arise from these targets set by WBES and the later findings should be interpreted with these caveats. One is that the sectoral composition is clearly too broad and our regressions may not sufficiently control for all the pertinent industry characteristics.[19] The second issue is

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[17] WBES asked respondents to rate eleven general business constraints as well as the detailed components of each individual general constraint. These general business constraints are: 1) financing, 2) infrastructure, 3) taxes and regulation, 4) policy instability or uncertainty, 5) inflation, 6) exchange rate, 7) functioning of the judiciary, 8) corruption, 9) street crime, 10) organized crime or mafia, 11) anti-competitive practices by government or private enterprise.

[18] Another example is anti-competitive practices as a business constraint. The WBES asked respondents to rate this business constraint as effected by both government and private enterprise. Thus not all the effect of this business constraint can be attributed to government policies.

[19] The WBES dataset does contain more objective indicators. The survey asked for information on the number of full and part-time employment and more detailed industry breakdowns (garment, agro-processing, heavy

that apart from sector composition there is no explicit justification for why a number of targets are fixed at 15 percent of the sample (as the floor). The concern is whether the survey may have over-sampled those firms with the specified attributes in those economies that have few of these firms in reality. There is no reason to expect the reported proportion of small (or large) firms, foreign firms and exporting firms should correspond exactly to their importance in the economy and there is no information about how these firms should be considered as a representative sample of all the firms in the country of their operation.

The third issue is the representativeness of the countries included in the WBES. The WBES covered 80 countries and one territory. One third of the countries are classified as low-income countries with per capita income of less than $760; about half of the sample comprises of middle-income countries, and a fifth are high-income countries (with per capita income above $9,360). The average GDP per capita of all the countries in the sample is $4,507 in 1999 (in the 1995 constant dollar). This compares with the world average of $5,491 on the same basis. Thus the WBES sample seems to lean more heavily on the less developed countries.

Variable descriptions

The basic approach here is to compare the survey responses of foreign and domestic firms to a number of questions pertaining to the regulatory environment in which they operate. The WBES breaks down the sampled firms by their foreign/domestic ownership categories and provides information on foreign ownership percentage on a portion of those firms classified as foreign-owned. The maximum number of firms in the WBES is 10,032.[20] Of these firms, 359 of them did not provide any information on their foreign/domestic ownership status; 1,820 firms reported having foreign ownership and 7,853 reported no foreign ownership.

Dependent variable

Our dependent variables are based on nine questions in the WBES about the tax and regulatory environment facing the sampled firms. These nine questions refer to Question (38a) and Questions (7a) through (7h) in the WBES and they are reproduced in Table 1. These nine questions probe into various regulatory dimensions that sampled firms perceived as “problematic for the operation and growth” of

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industry, etc.). The World Bank has declined the request by this author to obtain these data on confidentiality grounds.

their business. Question (38a) concerns one of the eleven general business constraints facing firms—taxes and regulations (TXREG). (The other ten general constraints are financing, infrastructure, policy stability, inflation, exchange rate, functioning of judiciary, corruption, street crime, organized crime and anti-competitive practices.) Because of its encompassing coverage and its unambiguous importance to firms, we will use TXREG as our main dependent variable.[21]

The other eight questions, Questions (7a) through (7h) in WBES, can be construed as various components of TXREG. These questions are business licensing (BL_REG), customs/foreign trade (CUS_REG), labor regulations (LAB_REG), foreign currency/exchange rate regulations (FRK_REG), environmental regulations (ENV_REG), fire, safety regulations (FIR_REG), tax regulations/administration (TADM_REG), and high taxes (HIT_REG). One of the ways to assess the strength of our regression results is by their consistency—in terms of the direction and the significance levels of our variables of interest—across these nine dependent variables.

Table 1 about here.

The responses to the WBES questions are on a four-point scale, from 1 (no obstacle) to 4 (major obstacle) and values of these responses form the basis for our dependent variables. Our dependent variable takes two forms. First, the dependent variable is coded as 1 if firms chose 4 in their responses and is coded zero otherwise. (The variable name is affixed number 4 to indicate this coding strategy.[22] For example, TXREG4 is equal to 1 if TXREG takes on a value of 4.) Second, we also use the original values of firms' responses as our dependent variable.[23] We use probit model for the binary dependent variables and the ordered probit model for the ordinal dependent variables. In part because we are primarily interested in the signs (and significance levels) of our coefficients, rather than the magnitude of their effects on our dependent variables, we are going to present probit results as our main findings. This is

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[20] There appears to be a discrepancy between the number of firms in the dataset and the number of firms which responded to the survey. According to the World Bank, 10,090 firms responded to the questionnaire. There is no explanation for this discrepancy.

[21] The abbreviations for our dependent variables are consistent with the original variable names used in a document named "Variable_descriptions" that accompanied the distribution of the WBES dataset. As noted in the text, however, some of the dependent variables used in the estimation have been transformed into 1/0 binary values and thus they do not correspond to the original values in the WBES.

[22] We have also formulated the dependent variable by setting to 1 for firms choosing 3 or 4 in their responses (and as 0 otherwise). The results, some reported in the paper, are not different.

[23] For some reason, the values of one business constraint variable—taxes and regulations—is reported as non-integer values for the African portion of the WBES. These non-integer values have been rounded into integer values in this paper.

also consistent with many studies utilizing survey data. (The ordered probit estimates are presented in Table 5. The main results are consistent across these two alternative formulations of the dependent variable.)

Table 2 about here.

Table 2 presents the average indicator scores of the responses to these nine WBES questions, broken down by foreign and domestic firms. The general constraint variable, TXREG, has a smaller average score for foreign firms as compared with domestic firms, suggesting that, descriptively at least, foreign firms perceive less constraints than domestic firms. This is also true for the two tax constraint variables, HIT_REG and TADM_REG. The remaining regulatory constraint variables do not exhibit a clear pattern. On business licensing (BL_REG), environmental (ENV_REG) and fire regulations (FIR_REG), foreign and domestic firms give virtually identical responses. Foreign firms seem to be slightly more constrained by the foreign exchange (FRK_REG) and customs regulations (CUS_REG) than domestic firms.

Implicit in this exercise is the assumption that foreign and local perceptions of a given business environment can be directly compared with each other.[24] One potential criticism of this assumption is that foreign and domestic firms may benchmark their evaluations in systematically different ways. For example, foreign firms, explicitly or implicitly, may use their own home economies as the benchmark when asked to evaluate the business environment of a host country. Domestic firms, on the other hand, may rely on local circumstances—for example, their own business environment in the past—as the benchmark. Foreign firms assess a business environment against cross-sectional standards while domestic firms do so against time-series standards. In the 1990s, the possibility for this perception bias was not trivial. Many governments in developing countries undertook reforms and improved their business environments against historical standards. Cross-sectionally, however, their business environments might still have failed to reach the standards of developed countries.

There is no evidence that foreign and domestic firms systematically differ in the way postulated above. As shown in Table 2, in the areas where foreign and domestic firms perceive regulations differently, the differences are in the degree, not in kind. A slightly more formal test bears out this conclusion. For TXREG, the simple two-way correlation of the country-average values between foreign and domestic firms is 0.82; for HIT_REG, it is 0.79 and for BL_REG, it is 0.72. Another test is to apply our specifications on a dependent variable that is judged, *ex ante*, to be firm-invariant. The idea is that to the extent that foreign and domestic firms differ in their assessments because of their firm-specific

[24] (Brunetti, Kisunko and Weder 1998) have a relatively detailed discussion of the potential sources of bias in cross-country survey data.

characteristics rather than because they face objectively different regulatory environments the firm-specific difference should show up on measures that are not supposed to vary between foreign and domestic firms. Two variables satisfy this firm-invariant condition in the WBES dataset. One is a firm's perception of the quality of telephone service (QTEL); the other is a firm's perception of quality of water service (QWAT). Because these are close to pure public goods, it will be difficult to vary the levels of service quality among different types of firms (although levels of service quality among different countries may differ). We will use these two variables as dependent variables to test the strength of our specifications to pick up the effects of truly firm-variant environments.

A separate issue is whether or not pressures by governments or political considerations on the part of firms may distort evaluations of business environments.[25] This is a real issue for this paper since an important part of our analysis is about the institutional effects on perceptions of business environments. There are two related concerns. First, firms in an institutionally weak country may provide overly rosy evaluations of their business environment as a way to curry favors with the authorities. They are motivated to do so because governments in institutionally weak countries typically have a lot of discretionary power. While one should not dismiss this concern *ex ante*, there are reasons to believe that this bias is not too severe. One piece of evidence is that the correlation between the WBES measures and the measures derived by using alternative methodologies and based on different sources from the WBES is not low. For example, the correlation between the country-average values of HIT_REG and the tax evasion measure in The Global Competitiveness Report 2001-2002 is -0.64.[26] (The higher values of the GCR measure indicate superior performance.)

The second concern is whether or not foreign and domestic firms are affected differently by the same set of political circumstances. For example, it is plausible to argue that an authoritarian government exercises more power over the owners and managers of domestic firms than those of foreign firms. Then one would expect that domestic firms should, on average, provide rosier evaluations of their business environments than foreign firms in authoritarian settings. If this problem is pervasive in the WBES data, it will be easier to validate the national preference hypothesis than the foreign privilege hypothesis and thus

[25] WBES researchers reported that the Chinese government did not allow firms to provide responses to corruption questions. For a number of Asian countries, the responses to questions on government interventions are all missing in the WBES.

[26] In calculating the correlation coefficient, I first converted the firm-level response values into the average country-level values. The correlations with the regulatory index devised by the Heritage Foundation are also high. The correlation with the country average values given by both foreign and domestic firms is about 0.48. (The Heritage Foundation index is the same as the WBES measure in that higher values indicate worse performance.)

the threshold to refute the conventional wisdom is higher, which should strengthen the results that will be shown in the later section. In reality, the two-way correlation of TXREG between domestic and foreign firms is in fact greater among more authoritarian countries than among more democratic countries. The two-way correlation of TXREG between foreign and domestic firms within the authoritarian group of countries is 0.85, as compared with 0.83 for countries ranked as democracies by our measure.[27]

Variables of interest

Our main variable of interest in this paper is a dummy variable, FOREIGN, denoting whether or not a firm is foreign-owned (equal to one if foreign-owned). Our interest is to see if FOREIGN is significant and if so in which direction. The national preference hypothesis predicts a positive FOREIGN coefficient—that is, foreign ownership is associated with a more severe infliction of business constraints. The foreign privilege hypothesis predicts a negative FOREIGN coefficient, i.e., foreign ownership is associated with an alleviation of business constraints compared with domestic ownership. The coefficient sign associated with FOREIGN (and its statistical significance) is the principal mechanism to adjudicate the national preference and foreign privilege claims.

WBES did not explain the criterion why the sampled foreign firms were selected and there may be selection biases that can distort our results. One potential bias has to do with over- or under-sampling of foreign firms relative to domestic firms. WBES set a floor of 15 percent for foreign firms in each country sample but in fact foreign to domestic sampled firms' ratios vary enormously, from the low of 2 percent (Armenia and Moldova) to 57 percent (Cameroon). Our remedy is to include variables that hopefully may capture any foreign/domestic selection biases at the country level. Most of the regressions include country dummies and for regression runs that do not have country dummies I include country ratios of foreign to domestic sampled firms.

Another type of bias has to do with the types of firms selected for sampling. If the best performing foreign firms were selected, it will be easier to validate the foreign privilege hypothesis than national preference hypothesis. The story is the other way around if, however, the worst performing foreign firms were selected. This is known in the literature as "kvetch factor." Kvetch factor refers to a propensity to either exaggerate or discount the objectively-extant regulatory obstacles. For example, a firm that is doing very well may systematically discount the regulatory obstacles it faces and conversely a

[27] Authoritarian countries here are defined as those countries ranked at or below 20th country in the voice and accountability measure by the World Bank's Governance Project. See text for a more detailed explanation.

firm that does poorly tends to do the opposite.[28] WBES contains data on firm performance in the last three years (measured by changes in sales). In some of the regression runs, we include this variable as a control of the "kvetch factor."

The other solution is to test the effect of "foreignness" as opposed to foreign status on regulatory treatments. One can logically argue that to the extent that foreign and domestic firms are treated differently it is possible that among firms already owned by foreigners more foreign-owned firms can be treated differently from less foreign-owned firms. The direction of this difference helps us adjudicate the foreign privilege and national preference claims. WBES contains data on foreign equity ratios (FER, given by foreign equity divided by total equity of a firm) for 2310 firms (many with zero values) and we substitute FOREIGN with this FER variable, in two ways. One is to run FER variable for all the available observations; the other is run the variable but exclude those observations with zero values. Negative FER coefficient lends support to foreign privilege hypothesis; positive FER coefficient lends support to national preference hypothesis.

Apart from adjudicating these two competing claims, there are a number of auxiliary issues that will be examined here. The first is to determine the sources of regulatory privileges, if any, enjoyed by foreign firms. Do they enjoy regulatory advantages across the board—i.e., over all domestic firms—or over a subset of domestic firms? A working hypothesis is that foreign firms do not necessarily command regulatory advantages across the board but they do so vis-à-vis the politically weak domestic firms.

To test this hypothesis, one needs to divide domestic firms into politically-connected and politically-weak categories and to benchmark foreign firms against these two types of domestic firms separately. *Ex ante*, one is hard pressed to find an unambiguous measure of political connection of firms and the solution here is to apply multiple definitions of political connections. We then judge the quality of our findings on the basis of the convergence of results generated by different methodologies. The first definition of political connections is government ownership. This is an intuitively straightforward definition as it is quite reasonable to assume that governments are motivated to protect firms in which they have an equity interest. The WBES contains a question about whether or not a given respondent firm

[28] See (Kaufmann and Wei 1999). In principle, the kvetch factor should not affect our findings on FOREIGN as much as other research projects that regress performance data on firms' perception. The reason is that the principal objective of this paper is to see if there is a difference between foreign and local perceptions of the same set of regulatory parameters rather than how firm performance affects business perceptions in general (or vice versa). Unless there is a systematic difference in the kvetch factor between foreign and domestic firms, the FOREIGN coefficient should not be affected by this psychological dynamic.

is government owned and I created a category of firms that are government-owned and domestic and then benchmarked foreign firms against these firms.

The second definition is subjective and it is based on a firm's perception about the extent that its view is taken into account by the government. This is from Question (25) in the WBES, "In case of important changes in laws or policies affecting my business operation the government takes into account concerns voiced either by me or by my business association." The response is given on a 1-6 point scale with one indicating the strongest influence on governments and six indicating none. A politically-connected domestic firm is coded as 1 if it scored 1 or 2 on this six-point scale and 0 otherwise.

We are also interested in exploring whether the regulatory treatments of foreign firms—be it national preference or foreign privilege—are predicated on particular institutional contexts. Again, prior theory and empirical works do not provide much guidance as to what the relevant institutional contexts are and our solution here is to try out different institutional contexts. We use the six institutional indicators devised by Kaufman, Kraay and Zoido-Lobaton for the World Bank Governance Project (hitherto referred to as KKZ institutional measures in this paper). These six indicators are available for two years, 1997 and 2000 and we will use the average values of these two years.[29] The six KKZ indicators refer to: 1) voice and accountability (VA97_00), 2) political stability (PS97_00), 3) government effectiveness (GE97_00), 4) regulatory quality (RQ97_00), 5) rule of law (RL97_00), and 6) control of corruption (CC97_00). These indicators are compiled on the basis of a large number of survey respondents in industrial and developing countries, as well as non-governmental organizations, commercial risk rating agencies, and think-tanks.

For the 174 countries in the Governance Project, the KKZ indicators range from -2.5 to +2.5, with higher values corresponding to better governance outcomes. (WBES, which covers 81 countries, has a narrower range of data.) Because our main analytical interest is to see how regulatory treatments of foreign firms—vis-à-vis domestic firms—may differ under different institutional contexts, it is easier, for illustrative purposes, to have categories—rather than levels—of institutions. We therefore break down all the WBES countries into two categories—institutionally developed countries and institutionally underdeveloped countries along the six KKZ institutional measures. The cutoff point between them is the 20^{th}–ranked country on the respective six KKZ indicators, which puts an institutionally underdeveloped country roughly in the bottom 25 percentile in the KKZ measures. For example, for the KKZ control of corruption measure, the cutoff value is -0.717 (Georgia) and all the countries ranked below and including Georgia are classified as institutionally underdeveloped on the corruption dimension. Six institutional

[29] For Cambodia and Belize, their 1997 values for control of corruption, government effectiveness and political stability are missing. The 2000 values are used instead.

dummy variable are created by setting them to 1 for countries below the respective cutoff points on the KKZ measures and 0 for countries above their cutoff points. Six interaction variables, between FOREIGN and the six institutional dummy variables, are then created (FOR_INST). (For a list of institutionally-weak countries on the corruption, government effectiveness, voice and accountability and rule of law dimensions, see Table 8.)

Control variables

In terms of firm characteristics, we follow the procedures set forth in previous works on business constraints, supplemented by a number of factors highlighted in the FDI literature.[30] The age of firms is sometimes used as a proxy for experience, with the assumption that more experienced firms are better able to deal with problematic situations. Size of firms is usually included as a regressor although its effect can be ambiguous. Regulations may discriminate against small firms, in which case size of firms will be negatively correlated with business constraints. On the other hand, small firms can be more adept at evading regulations in ways that large firms cannot and therefore they may perceive tax regulations as less severe business constraints for that reason. Capital intensity is also included in prior works. The idea is that high cost of finance may increase the severity of constraints for firms with capital-intensive production processes. Export is typically included on the assumption that exporting firms may face different kinds or levels of constraints from those domestically-oriented firms.

WBES allows us to devise a number of firm-level controls along these lines. A dummy variable is created and is set to 1 if a firm is classified in the WBES as a large firm, defined as a firm with more than 500 employees. The alternate measures of firm size are the log values of the sales revenue and fixed asset value of a firm. The WBES collected data on categorical answers as to whether a firm exports or not. A dummy variable denoting the export status of a firm (1=exporting firms) is included in all the regression runs. In some of the specifications, as a further check, export/sales ratio is used as an alternative measure of a firm's export orientation. Standard capital intensity measures are not available in WBES but WBES contains data on sales and fixed assets of firms for some of the observations. Some of the regression runs include log values of sale/fixed asset ratios as an imperfect measure of capital intensity of firms.

As checks of robustness of the regression findings and as controls for perception biases and transfer pricing, we have also added and experimented with an additional set of firm-level controls. One is a dummy variable equal to 1 if a firm has operations in countries other than the country in which it operates at the time of the WBES. This variable can be used to control two dynamics. One is that a firm

[30] Some of the works also include characteristics of entrepreneurs as regressors. See (Pissarides, Singer and Svejnar 2003). We do not have such data.

with international operations may evaluate a business environment differently from one with only local knowledge. The other dynamic has to do with sensitivity on the part of firms to particular aspects of a business environment. Take high taxes as an example. If foreign firms are indeed found to be less constrained by high taxes than domestic firms, a plausible explanation is that foreign firms can evade host tax regulations more easily than domestic firms, not, as the foreign privilege hypothesis suggests, that foreign firms are treated better by host tax authorities. One mechanism for foreign firms to evade host tax burdens is transfer pricing, a practice of under-invoicing exports and/or over-invoicing imports, designed to transfer profits to their affiliates located in other countries. Because transfer pricing reduces a firm's tax liability to a host government, it also reduces a firm's exposure to the characteristics of the tax regime in a host country. To control for transfer pricing, we include an international operation dummy, firms' ranking of import clearance and of exchange rate regime. The idea here is that a firm that engages in more international operations, proxied by a greater sensitivity to import and exchange rate regimes, may be more capable of transfer pricing.

In all the regression runs, we have included four industry dummy variables (out of a total of five). These industries are manufacturing, service, agriculture, construction and an unknown category labeled as "others." Perceptions of business environments are affected both by firm-level as well as country-level factors. To control for the country-level influences, we include country dummies for all countries (but one). We also experiment with regressions without country dummies or with a set of country-level economic and institutional controls as well as regressions that contain both country dummies and country-level controls. The following country-level controls are used: 1) FDI stock/GDP ratios in 1999, 2) log values of per capita real GDP in 1999 (in the constant 1995 dollar), and 3) the average real growth of per capita GDP between 1991 and 2000. The source of all the economic controls is the World Development Indicators, except for FDI stock/GDP ratios, which come from World Investment Report.[31] The country-level institutional controls are the six KKZ indicators. In addition, in order to remedy the potential selection biases in the WBES sample, in regressions without country dummies we have also included country ratios of sampled foreign to sampled domestic firms to control for any idiosyncratic factors that lead to more or less sampling of foreign firms in some countries than in others.

[31] We use the 1999 GDP per capita data from the World Bank's World Development Indicators (WDI). The data are in the 1995 constant dollars. The data are not available for one country in the dataset, Nicaragua, and we use the 1998 GDP per capita income instead. For Singapore, trade/GDP data are not available from WDI.

The Findings

Baseline models

Table 3 about here.

Table 3 presents the descriptive statistics of the main variables used in the regression analysis. Table 4 presents the probit estimates of our baseline specifications. There are nine dependent variables, each formulated as taking values of 1 for response equal to 4 or 0 otherwise. These nine dependent variables are: 1) tax and regulations (TXREG4), 2) business licensing (BL_REG4), 3) labor regulations (LAB_REG4), 4) environmental regulations (ENV_REG4), 5) fire and safety regulations (FIR_REG4), 6) high taxes (HIT_REG4), 7) tax administration (TADM_REG4), 8) customs regulation (CUS_REG4), and 9) foreign exchange regulations (FRK_REG4). (The number 4 is affixed to indicate the way the variable is coded.) The variable, FOREIGN, is a dummy variable denoting the respondent status as a foreign firm. All the regressions include industry and country dummy variables. For specification (1), the firm-level controls refer to a firm's export status, a dummy variable denoting a large firm (with more than 500 employees), and a dummy variable denoting a startup firm (i.e., founded since 1994), and logged ratios of sales to fixed assets.

Specifications (2) through (10) omitted the startup firm dummy and logged ratios of sales to fixed assets. The reason is that inclusion of these two variables would result in a reduction of more than 1,000 firms. More seriously, the African portion of the WBES did not collect data on firm age and thus including the new firm dummy would lead to an exclusion of all the African firms. Data on sales and fixed assets are seriously incomplete in WBES. A comparison of (1) and (2) shows that including these two variables has no appreciable effect either on the sign or the significance level of FOREIGN. (If anything, excluding the African sample in fact is favorable to the foreign privilege hypothesis.) We thus drop them in the subsequent regressions.

Table 4 about here.

To save space, the coefficients of industry and country dummies are not reported in the table. Out of ten regression runs, FOREIGN is positive in three but none reached statistical significance levels. FOEIGN is negative in seven specifications. Out of this seven, six are significant at a 1 percent level when the dependent variable is, alternately, TXREG4 (with or without startup dummy and capital intensity measure), LAB_REG4, ENV_REG4, HIT_REG4, and TADM_REG4. This initial set of regressions provides strong evidence in support of the foreign privilege hypothesis and not a single coefficient in support of national preference hypothesis.

In order to show that the regulatory constraint variables in fact do track the firm-variant treatments, let us contrast the findings on TXREG4 with those on firm-invariant variables such as service quality of telephone (QTEL4) and water (QWAT4). Regression (1) in **Table 5** runs QTEL4 as the dependent variable and it produces an insignificant FOREIGN coefficient (Z-statistic=-0.24). The Z-statistic for FOREIGN coefficient with QWAT4 as the dependent variable is 0.17 (not shown in the table). Regression (2) substitutes FOREIGN with FER (i.e., foreign equity ratio). FER is negative and is statistically significant. FER is zero for 646 observations and there is a question whether the original FER data are distorted when so many domestic firms failed to provide information on FER. We resorted to two solutions. First, we restricted the sample to those firms classified as foreign firms only (i.e., FOREIGN=1). FER is still negative and statistically significant at 5 percent. Second, the sample is restricted to those firms with FER greater than 0. FER is unaltered. (The latter two results are not reported in the table.)

The dependent variable for Regression (3) in Table 5 is TXREG3_4. TXREG3_4 takes on the value of 1 when firms chose 3 or 4 in their responses (and 0 otherwise). FOREIGN retains the negative sign and is significant at the 10 percent level. In Regression (4), the dependent variable is the original values of TXREG in the WBES. The ordered probit estimation produced a negative and statistically significant FOREIGN coefficient.

Table 5 about here.

The dependent variable for Regressions (5) through (11) is TXREG4 with various specifications of the models. Regressions (5), (6), and (7) dropped, respectively, firm-level controls, industry and country dummies. FOREIGN is unaltered. In Regression (8) we experimented with only one independent variable, FOREIGN, and FOREIGN continues to be negative and statistically significant. Regressions (9) and (10) substitute country dummy variables with a number of economic and institutional country-level variables. Regression (11) includes both country dummies and country-level economic and institutional controls. FOREIGN is unaffected. (The country-level variables are: 1) FDI stock/GDP ratio in 1999, 2) log value of per capita GDP in constant 1995 dollars, 3) per capital GDP real growth between 1991 and 2000, 4) ratios of sampled foreign to domestic firms in the WBES, 5) six KKZ institutional indicators.)

Table 6 examines the possibility that FOREIGN connotes meanings other than what is intended here—regulatory treatment of foreign firms relative to domestic firms. The first possibility is that foreign and domestic firms are affected by the "kvetch factor"—a tendency to exaggerate or discount the objectively-extant business constraints on account of past firm performance. If foreign firms are better performing than domestic firms, foreign firms are likely to be rosier in their evaluations of the business environments than domestic firms. The negative FOREIGN coefficient would be consistent with this conjecture. Regression (1) of Table 6 includes a variable denoting percentage changes in sales in the past

three years and provides no evidence that past firm performance contributed to the negative FOREIGN effect.

Table 6 about here.

Another possibility is that the findings on FOREIGN are driven by the differences in the nature of business between foreign and domestic firms rather than by the differences in the regulatory treatments. Two scenarios can be imagined. In one, foreign firms export and import more than domestic firms and they place more of their business transactions outside the regulatory reach of the host governments as compared with domestic firms. In the other scenario, foreign firms use their international transactions as a way to evade the regulatory strictures of the host governments. For example, foreign firms can engage in transfer pricing to reduce their host tax liabilities in ways that the trapped domestic firms cannot. High taxes and tax regulations are thus less onerous on foreign firms not by design but in effect.

First, let me note that foreign privilege is observed with respect to those regulatory dimensions that have little to do with cross-border transactions, such as LAB_REG4 and ENV_REG4. Nevertheless, we can devise explicit controls of the cross-border transaction differences among firms. Five regression runs under columns (2) and (3) control for various factors pertaining to differences in nature of business. The two regressions under Column (2) attempt to control for the import activities of firms. To the extent that foreign firms import more than domestic firms, they are less subjected to host regulations. [32] For some reason, WBES failed to collect data on the import activities of the respondent firms and we have to devise other ways to proxy for import activities. [33] WBES contains a question about the number of days it takes for a firm to clear import customs. We use this measure as an indicator of a firm's import propensity. The second measure is a firm's perception of foreign trade/customs regulation (CUS_REG), which was a dependent variable in one of the regressions in Table 4. The idea here is that this variable captures, if imperfectly, a firm's sensitivity to import regimes given its import propensity. Including both of these variables separately does not make FOREIGN statistically insignificant, although the level of significance declined when import clearance days served as a regressor. A main reason, however, is a sharp reduction of number of observations resulting from the inclusion of this variable. The data of this variable are not

[32] This is especially true for foreign firms operating in developing economies where many of the foreign firms engage in processing activities. In previous research, researchers have demonstrated the greater import intensity on the part of foreign firms. There is a long history of this research. See (Lall 1978) for a summary.

[33] WBES did not ask for information on import even though the survey asked for information on export/sales ratios. This glaring omission is both unfortunate for researchers and somewhat strange. By 2000, many countries have liberalized their export sector—and in fact some governments actively promote export production. One would have thought that import restrictions would be a more binding constraint on firm operations.

available for 3685 firms, most located in developing countries (where foreign privilege seems to be more prominent).

Three regressions under Column (3) control for the transfer pricing propensity of firms. Two additional firm-level controls (on top of export status and size dummies) are added: 1) a dummy variable denoting whether a firm has operations in other countries and 2) a firm's perception of exchange rate as a general constraint. The rationale is that these variables capture some of dynamics related to the familiarity with and sensitivity to cross-border transactions. To the extent that this familiarity/sensitivity and that propensity to engage in transfer pricing differ between foreign and domestic firms, controlling for these firm-level differences helps separate the regulatory effect from business-specific effect associated with FOREIGN. FOREIGN remains negative and highly statistically significant. *Ex ante*, one might argue that transfer pricing affects the tax constraints most directly rather than general regulatory constraints. Two tax constraints, HIT_REG4 and TADM_REG4, are run as dependent variables in two separate regression runs under Column (3). FOREIGN is negative and statistically significant in both.

The two regression runs under Column (4) deal with the possibility that the regulatory treatments of foreign firms are endogenous rather than exogenous. This can arise if foreign and domestic firms have different propensities or capabilities to bribe government officials into granting preferential treatments as a result. While this scenario does not invalidate the foreign privilege hypothesis per se, it does point to a different mechanism from the one postulated in this paper—that governments privilege foreign firms as a policy choice. Two variables are entered separately to control for firms' influences on governments. One is based on Question (25) in the WBES about whether or not their views are taken into account by the government. The higher value indicates less influence on government. The other is firms' estimate of the amount of time they spend dealing with bureaucracy. Both of these variables themselves are positively related to TXREG, indicating that firms with lower self-rated influences are more constrained and that firms needing to spend more time with government are more constrained. These two voice/effort variables do not affect FOREIGN in terms of its sign and the significance level.

Exploring mechanisms of foreign privilege

Next, we examine three mechanisms whereby foreign privilege may arise. The first mechanism is at the firm level and we propose the idea that foreign firms may hold regulatory advantages not so much against all domestic firms but against a subset of domestic firms. It is important to note that FOREIGN in the preceding regression runs are benchmarked against all domestic firms in WBES and that majority of the firms in the WBES are small and medium sized private firms. Thus an accurate reading of the results so far is that FOREIGN is negatively related to regulatory constraints vis-à-vis the numerously represented domestic firms in WBES. To test the hypothesis that foreign privilege might be dependent on

the political power of the benchmarked domestic firms, we benchmark foreign firms separately against domestic firms with different levels of political power.

To simplify the illustration, we divide all the domestic firms into two categories—politically-connected and politically-weak firms. We measure political power in two ways. The first measure is government ownership and we classify all the domestic firms with government ownership as politically-connected firms and all the domestic firms without government ownership as politically-weak firms. The second measure is subjective and we use Question (25) in the WBES about whether governments take into account of the voices of firms when formulating regulatory and policy changes. Regressions in Panel (1) in the top half of Table 7 benchmark foreign firms against the politically-powerful domestic firms, along the two aforementioned dimensions of the political power. Panel (2) regressions in the bottom half of Table 7 benchmark foreign firms against the politically-weak domestic firms. The results appear in Table 7.

Table 7 about here.

Four dependent variables, TXREG4, LAB_REG4, HIT_REG4 and CUS_REG4, are selected for illustration.[34] TXREG4 is our main dependent variable and is a measure of the general business constraints, whereas labor, tax and foreign trade regulations are unambiguously important to all firms and the findings on them may shed more light on regulatory environments facing firms. The independent variables are identical to those used in Table 4: FOREIGN, export status dummy, large firm dummy, industry and country dummies. (To save space, only coefficients for FOREIGN and constant are reported.)

In Panel (1), when benchmarked against the politically-connected domestic firms, only one FOREIGN coefficient is negative—but lacking in statistical significance—out of eight regressions. This finding suggests that foreign firms do not hold regulatory advantages against the politically-connected domestic firms. In fact, there is some evidence that foreign firms may hold regulatory disadvantages against the politically-connected domestic firms. This result is more apparent when the political power of firms is measured subjectively and when the dependent variable refers to foreign trade regulations (CUS_REG4). Under Regression (2d), the positive FOREIGN coefficient reached statistical significance.[35] (Under (2c), the subjective measure of political power and HIT_REG4 as the dependent

[34] Other dependent variables produced mainly insignificant results. It should be emphasized that none of the regressions produced results consistent with the national preference hypothesis, i.e., a positive AND statistically-significant coefficient.

[35] This result survives the inclusion of exchange rate constraint as a measure of import sensitivity, but not the inclusion of import clearance days.

variable produced a positive FOREIGN coefficient significant at a 15 percent level, with a Z-statistic at 1.46.)[36] When benchmarked against the politically-weak domestic firms in Panel (2), there is a substantial change in the behavior of FOREIGN. Now, six out of eight FOREIGN coefficients are negative as well as statistically significant (all at a 1 percent level). The lone exception is CUS_REG4 where FOREIGN is positive but not statistically significant.

The findings in the two panels of Table 7 taken together suggest two conclusions. First, foreign firms are only privileged against the politically weak domestic firms, but not against the politically-connected firms. Foreign firms may be even disadvantaged against the powerful domestic firms in the area of foreign trade/customs regulations. This finding does lend support to the national preference hypothesis but only within this narrow and well-defined arena. Second, foreign firms do not hold advantages in all the regulatory dimensions against the politically-powerless domestic firms (such as in CUS_REG4), but they do so in some of the most important dimensions such as in labor and tax regulations. In addition, in areas where the FOREIGN coefficient lacks significance, foreign firms do as well—or as poorly—as the politically-weak domestic firms. Foreign privilege is absent but so is national preference.[37]

The second mechanism we explore is the institutional context in which foreign privilege (or national preference) may arise. Different institutional contexts may impose different constraints on governmental behavior. For example, in a democracy, governments may be constrained from conferring largess on foreign firms in excess of what domestic firms receive. This fits with the classic national preference model. For authoritarian governments, the postulation is theoretically ambiguous. On the one hand, they may be less constrained from privileging foreign firms, but on the other hand, they are also less constrained from privileging domestic firms as well.

Table 8 presents some descriptive data on countries judged as the least institutionally developed on the four KKZ dimensions: control of corruption (CC97_00), government effectiveness (GE97_00), voice and accountability (VA97_00) and rule of law (RL97_00). The countries appearing in the table are ranked at or below the bottom 20th country on their respective KKZ measures. The KKZ indicators are averaged for 1997 and 2000. TXREG scores in the table refer to the country-average values of the TXREG scores reported by firms in given countries. The bottom row presents summary statistics.

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[36] The other five dependent variables produced insignificant FOREIGN coefficients when benchmarked against the politically strong domestic firms, except for ENV_REG4. In ENV_REG4, FOREIGN is negative and statistically significant vis-à-vis both the politically-connected domestic firms and politically-weak domestic firms.

[37] We ran all the regulatory dependent variables. FOREIGN is not significant in a number of regressions, but none of the results contradicts the findings generated by TXREG4, LAB_REG4 and TXREG4.

Table 8 about here.

There are some interesting patterns in the data. First, countries overlap quite substantially among these four categories. Most countries appear in at least two categories. Second, as shown in the summary statistics, domestic firms average higher TXREG scores across all institutional categories, suggesting that domestic firms feel more constrained than foreign firms across the board. Of the thirty-eight countries included in the table, TXREG scores reported by domestic firms are higher than those by foreign firms in twenty-one of them. Within each institutional category, domestic firms report higher TXREG scores than domestic firms on all four KKZ measures. Third, comparing the TXREG scores across institutional categories shows that for domestic and foreign firms alike, regulatory constraints are most severe in countries with poor government effectiveness and least severe in authoritarian countries.

The dependent variable in Table 9 is TXREG4. The WBES countries are divided into institutionally-developed and institutionally-underdeveloped countries along the six KKZ institutional measures. An institutional dummy is created and takes on the value of 1 for institutional under-developed countries and 0 for institutionally-developed countries. Institutional underdevelopment is defined as achieving a score on the KKZ measures at or below 20th country in the WBES. (This is an arbitrary demarcation for sure and other equally plausible definitions can be devised. The idea here is to treat good institutions as a norm as our definition leads to a minority of firms—about 25%--being classified as located in institutionally-underdeveloped countries.) The institutional dummy variables used in the regressions in Panel (1) of Table 9 are based on the KKZ measures of control of corruption, government effectiveness, and regulatory quality. The institutional dummy variables in Panel (2) of Table 9 are based on the KKZ measures of rule of law, political stability, and voice and accountability.

Table 9 about here.

All the regression specifications contain FOREIGN, an interaction variable between FOREIGN and institutional dummy variables (FOR_INST), and the firm-level and industry controls used in generating the regression results reported in Table 4. (The firm-level controls are export status and large firm dummy variables; industry controls refer to the four industry dummy variables for the five broad economic sectors surveyed by WBES.) For each institutional dummy, three specifications are tried. Specifications (a) includes, in addition to FOREIGN, FOR_INST and standard firm- and industry-level controls, the institutional dummy itself and country dummies. Specifications (b) substitute country dummies with a number of country-level variables—i.e., 1) FDI stock/GDP ratios in 1999, 2) log value of per capita income in 1995 dollars, 3) the real growth rate of per capita income between 1991 and 2000, and 4) the ratio of the number of sampled foreign firms to the sampled domestic firms. Specifications (c) omit the institutional dummy variable in order to show the independence of FOR_INST on the inclusion of the institutional dummy variable itself.

Altogether there are 18 individual regressions generated by three specifications per each of the six KKZ measures of institutional quality. FOREIGN is negative in each one of these 18 regressions and it is statistically significant in 12 out of 18 regression runs. This is fairly strong evidence that foreign privilege is present in institutionally-strong countries. FOR_INST has acquired a negative sign in 15 out of 18 regression runs but only six out of these 15 negative coefficients reached a statistically significant level. (One out of three positive FOR_INST coefficients is statistically significant, i.e. Regression (6a)). There is limited support for the idea that foreign privilege is more substantial in institutionally-weak countries than institutionally-strong countries. Of the six KKZ measures, the corruption measure produces the most consistent results. All three of the FOR_INST based on the KKZ measure of control of corruption are negative and statistically significant. (This finding obtains when the regressions also include the five other KKZ institutional measures.) Thus while the evidence is not strong that foreign privilege is present in institutionally-weak countries across all the institutional categories, there is some evidence that corruption enhances foreign privilege.

Concluding remarks

This paper has found consistent evidence in support of foreign privilege hypothesis and almost no support for the national preference hypothesis commonly assumed in the FDI literature. At least as of the turn of the 21th century, foreign firms seem to enjoy substantial regulatory advantages over domestic firms. This finding is robust to a number of controls and alternative specifications. There is also evidence that these regulatory advantages may vary depending on the political power of the benchmarked domestic firms and depending on the institutional settings in which a foreign firms operates. In general, foreign firms seem to command more regulatory advantages vis-à-vis less politically-powerful domestic firms and more regulatory advantages in countries characterized by corruption.

Drawing the right policy implications from our findings would depend on two additional sets of issues beyond the scope of this paper. One has to do with our normative priors about regulations. A positive view of regulations would lead one to conclude that strengthening regulations on foreign firms is in order. A negative view of regulations would favor policies that encourage more FDI and/or deregulations of domestic firms. While it is beyond the scope of this paper to justify one set of priors over the other set of priors about regulations, it should be noted that recent evidence on regulations favors the negative view of regulations (Djankov, La Porta, Lopez-de-Silanes and Shleifer 2002).

Even if it is the case that fewer regulations are better, one can still debate about the mechanisms to deregulate. In a way, championing FDI is an indirect way to deregulate an economy whereas improving the regulatory environment for both foreign and domestic firms is more straightforward. But one could argue that deregulation by stealth is politically expedient (--this rationale is consistent with our

limited finding that foreign privilege is more pronounced in countries with low government effectiveness). This more charitable interpretation is inconsistent with our findings that even countries with strong institutions also privilege foreign firms, especially over the politically-powerless domestic firms. The latter finding suggests that privileging foreign firms is not always used as deregulation by stealth; instead foreign firms are privileged maybe because governments can afford politically to repress the weak domestic firms.

Drawing the right policy implications would also depend on an empirical determination whether there is a mere lag or a delay in regulatory improvement between foreign and domestic firms. A lag means that regulatory improvement of foreign firms is followed by regulatory improvement of domestic firms over time; a delay would imply that a regulatory improvement for foreign firms may in fact prolong the regulatory constraints on domestic firms, possibly because governments successful in attracting FDI are less motivated to improve regulatory environment for domestic firms. Within the confines of the WBES data, we are unable to sort out these two scenarios.

Appendix: Prior research in regional studies on foreign privilege

The national preference claim is often assumed than tested. Some of the in-depth country-case studies cast doubt on this claim by documenting a systematic policy bias in favor of foreign firms on the one hand and a bias against politically-weak domestic firms on the other. Here I briefly summarize research on three regions/countries, Latin America, China and Malaysia.

The pioneering work that documents foreign privilege in Latin America is by an Argentine political scientist, Guillermo O'Donnell. (O'Donnell 1978) and (O'Donnell 1979). O'Donnell was primarily interested in explaining the rise of authoritarian regimes in Latin America in the 1960s and 1970s, rather than foreign privilege *per se*. But he noted a correlation between the rise of authoritarianism and a deep industrialization push, which he linked with a deep FDI dependency among Latin American countries. The industrialization required massive investment resources because the second-stage import substitution strategy was designed to acquire the capacity to manufacture sophisticated intermediate and capital goods. This economic imperative dictated a number of political and policy developments. One was to suppress the populist and consumption demands on the part of the national bourgeoisie, professionals and the members of the middle class. This is the idea of "political exclusion," a formulation used by O'Donnell to explain the rise of authoritarianism in the region.

The other policy course was to heavily court multinational corporations (MNCs), which controlled the vital technological and financial resources that enjoyed a high premium given the policy emphasis on capital-intensive industrialization. To be sure, the MNCs were not to be given a free rein; instead there was an "elective affinity" between national oligopolistic and state-owned corporations and MNCs. This is how O'Donnell explained the FDI dependency of Latin American economies (O'Donnell 1978, p. 18):

> [Foreign investors] require particularly favorable conditions—which may be on the verge of a pseudo-investment for their entry. All of this cannot but appear as confirmation of the worst fears of local capital…; any extrapolation from such first investments ends very close to totally internationalizing the most dynamic and profitable sectors of the economy.

Our second case study example comes from China. China has been commonly touted as a shining example of economic success, in part because of its ability to attract a massive amount of FDI. (Huang 2003) challenges this conventional wisdom and he shows that China's huge FDI absorption was in part driven by the inefficiencies of its financial system. Its financial system allocated capital to the least efficient domestic firms—SOEs—at the expense of the most efficient domestic private firms. The result was a lowering of competitiveness of domestic firms across the board. The Chinese government then

expended considerable financial and policy resources to court FDI and foreign firms in order to make up for the shortcomings of its own corporate sector. The regulatory advantages enjoyed by foreign firms over domestic private firms were substantial. As noted by a former top Chinese legislator, of the 80 broad economic sectors, foreign firms were allowed entry in 60 of them compared with 40 for domestic private firms (Huang 2003).

While China's high FDI dependency is a byproduct of its support of SOEs, a number of studies of Malaysia argued that the heavily FDI-focused New Economic Policy (NEP) was used by the government to intentionally eclipse an economically efficient but politically suspect indigenous entrepreneurial class—the ethnically Chinese businesses. NEP, enacted in the aftermath of the 1969 racial riots, aimed at creating income and wealth parity between the *bumiputra* majority and the Chinese minority. NEP imposed substantial financial constraints and stringent divestiture requirements—that the Chinese businesses had to transfer 30 percent of equity to bumiputra controls after reaching a certain size—on Chinese owned businesses.

The enactment of NEP coincided with a rapid expansion of FDI in the Malaysian economy. In 1970, FDI accounted for 11 percent of gross capital formation; in 1974, the ratio reached 20 percent and remained around 14 to 15 percent until the 1983 debt crisis (World Bank 2003). Beginning in 1985, FDI rose substantially again, to 25 percent of gross capital formation in 1992. As FDI rose, private domestic investments fell (Salleh and Meyananthan 1997, pp. 295-296). In the late 1970s, the Chinese share of corporate equity fell below 30 percent for the first time in history, against 70 percent in 1970 (Drabble 2000, p. 244). According to one estimate, 60 percent of the domestic investment contraction was attributed to the Chinese reluctance to invest. Morgan Guaranty estimated that the total capital flight during the 1976-1985 period amounted to 30 billion Malaysian ringgit.

Accounts by several Chinese businessmen are revealing.[38] Among those who decided to leave the country or diversify to overseas locations were some of the most prominent Chinese businessmen in Malaysia, such as Robert Kuok, Tan Chin Nam, and Khoo Kay Peng. The case of Robert Kuok illustrates a particularly pernicious effect of NEP--hemorrhaging indigenous entrepreneurial talents and capital. Robert Kuok, a Fujianese dubbed "the most enigmatic" of the Chinese businessmen in the post-colonial Malaysia, ran a major trading operation in salt, sugar and rice in the 1950s and 1960s. He had close links with powerful Malaysian political figures in the 1960s and was appointed director of government-owned airline, shipping company and banks. In 1975, the year of the Investment Coordination Act (ICA) enactment, made Hong Kong his corporate headquarters and settled there. Although he never offered an explicit explanation for this decision, it is widely known that Kuok was critical of the increasingly

[38] This account of Robert Kuok is based on (Gomez 1999, pp. 40-49).

interventionist policy stance under NEP. In a speech he delivered in 1989, he declared that "over-regulation is not conducive for economic expansion. Sometimes we throw in a whole lot of regulations and then offer incentives in the way of exemptions form some of these regulations. Malaysia… is perceived as being over-regulated." Geh Ik Cheong, chairman of one of the subsidiaries in Kuok's business empire, was more direct. In 1993, he was quoted as saying, "A lot of the opportunities here (in Malaysia) have attracted many up-and-coming Bumiputera companies. We haven't always felt comfortable competing with them. So as a group we have taken the step to expand internationally."

An instrument to enforce policy biases in favor of foreign firms is the divestiture requirement imposed by the 1975 Investment Coordination Act (ICA). Under the ICA, a non-*bumiputra* business was required to transfer 30 percent of its equity to *bumiputra* controls but this requirement was waived for foreign firms exporting 100 percent of their output. The Promotion of Investments Act, promulgated soon after the enactment of ICA, allowed foreign investors 100 percent ownership if they exported 50 percent of output or they sold 50 percent of their output to Foreign Trade Zones (Drabble 2000, pp. 245-246). An example of using FDI to bypass the indigenous Chinese capabilities comes from Malaysia's push into the automotive industry in the early 1980s. Joint ventures were established between foreign firms and the state-owned Heavy Industries Corporation of Malaysia (HICOM). Proton, the national car project and a joint venture with Mitsubishi, completely sidestepped the eleven existing automobile assemblers—all owned by Chinese.[39]

This substitution of domestic with foreign capital led a number of scholars to speculate that the Malaysian state intentionally used foreign capital to counterbalance the Chinese business sector. Contracts were often awarded to Malay firms at substantially higher bids compared to what the Chinese competitors offered. Malay firms, which lacked execution capabilities and necessary business skills, then teamed up with Korean or Japanese firms to execute the projects. FDI was, in the words of (Lee and Tan 2000, pp. 138-139), "an ethnic bypass strategy." Another Malaysian scholar, (Hoong 1991, p. 175), would put it this way:

> [F]or many years, the country has fallen short in their supply [of capital and entrepreneurship] and courted foreign investors to bring in these vital resources. However, it should be noted that some amount of domestic capital and entrepreneurship has always been available. Unfortunately, in the past, their availability was more identified with one ethnic group and therefore they were not optimally utilized….

[39] This section on the auto industry is primarily based on (Lim 1991) and (Jomo and Gomez 1997, p. 357).

Tables

Table 1 Survey questions on taxes and regulations in WBES

Question 38 in WBES	Please judge on a four-point scale how problematic are the following factors for the operation and growth of your business. Please circle the most important obstacle:			
	No obstacle	Minor obstacle	Moderate obstacle	Major obstacle
(c) Taxes and regulations (TXREG)	1	2	3	4
Question 7 in WBES	Please judge on a four-point scale how problematic are these different regulatory areas for the operation and growth of your business. Please circle the most important obstacle:			
(a) Business licensing (BL_REG)	1	2	3	4
(b) Customs/foreign trade regulations in your country (CUS_REG)	1	2	3	4
(c) Labor regulations (LAB_REG)	1	2	3	4
(d) Foreign currency/exchange regulations (FRK_REG)	1	2	3	4
(e) Environmental regulations (ENV_REG)	1	2	3	4
(f) Fire, safety regulations (FIR_REG)	1	2	3	4
(g) Tax regulations/administration (TADM_REG)	1	2	3	4
(h) High taxes (HIT_REG)	1	2	3	4

Source: The entire WBES core survey can be found in (Batra, Kaufmann and Stone 2003, pp. 93-107)

Table 2 Mean and standard deviation values of the original response values by foreign and domestic firms: 1=No obstacles; 4=Major obstacles

	Foreign firms			Domestic firms		
	No. of observations	Mean value of responses	Standard deviation values	No. of observations	Mean value of responses	Standard deviation values
Taxes and regulations (TXREG)	1699	2.73	0.96	7406	3.00	0.98
Business licensing (BL_REG)	1746	2.08	1.03	7466	2.16	1.06
Customs/foreign trade regulations (CUS_REG)	1687	2.4	1.0	6572	2.18	1.08
Labor regulations (LAB_REG)	1755	2.31	1.01	7562	2.16	1.06
Foreign currency/exchange regulations (FRK_REG)	1730	2.03	1.02	6897	1.94	1.06
Environmental regulations (ENV_REG)	1709	2.00	0.95	7337	1.99	1.0
Fire, safety regulations (FIR_REG)	1730	1.86	0.89	7506	1.86	0.93
Tax administration (TADM_REG)	1719	2.62	1.02	7494	2.79	1.06
High taxes (HIT_REG)	1768	3.07	1.03	7635	3.3	0.99

Source: WBES.

Table 3 Descriptive statistics of main firm-level variables

Variable	Definition/Source	Mean	Standard deviation	Min	Max	Number of observations
TXREG	Original values of tax and regulation constraint in WBES. WBES question 38.	2.93	0.98	1	4	9402
TXREG4	Dummy for top constraint score (TXREG=4)			0	1 (3229)	9402
BL_REG	Original values of business licensing constraint in WBES. WBES question 7a	2.07	1.06	1	4	9523
BL_REG4	Dummy for top constraint score on business licensing (BL_REG=4)			0	1 (1201)	9523
LAB_REG	Original values of labor regulations constraint in WBES. WBES question 7b	2.18	1.04	1	4	9586
LAB_REG4	Dummy for top constraint score on labor regulations (LAB_REG=4)			0	1 (1327)	9586
ENV_REG	Original values of environmental regulations constraint in WBES. WBES question 7c	1.99	0.99	1	4	9345
ENV_REG4	Dummy for top constraint score on environment (ENV_REG=4)			0	1 (885)	9345
FIR_REG	Original values of fire and safety regulations constraint in WBES. WBES question 7d	1.86	0.92	1	4	9532
FIR_REG4	Dummy for top constraint score on fire and safety (FIR_REG=4)			0	1 (615)	9532
HIT_REG	Original values of high taxes constraint in WBES. WBES question 7e	3.25	1.0	1	4	9713
HIT_REG4	Dummy for top constraint score on high taxes (HIT_REG=4)			0	1 (5411)	9713
TADM_REG	Original values of tax administration constraint in WBES. WBES question 7f	2.76	1.05	1	4	9497
TADM_REG4	Dummy for top constraint score on tax administration (TADM_REG=4)			0	1 (2843)	9497
CUS_REG	Original values of customs regulations constraint in WBES. WBES question 7g	2.23	1.07	1	4	8560
CUS_REG4	Dummy for top constraint score on customs regulation (CUS_REG=4)			0	1 (1269)	8560
FRK_REG	Original values of foreign exchange regulations constraint in WBES. WBES question 7h	1.96	1.05	1	4	8927
FRK_REG4	Dummy for top constraint score on foreign exchange regulation (FRK_REG=4)			0	1 (1049)	8927
FOREIGN	Dummy for foreign firms. WBES question ix.			0	1 (1820)	9673
Export status dummy	Dummy whether a firm exports. WBES question x.			0	1 (3373)	9463
Large firm dummy	Dummy for firms with more than 500 employees. WBES question ii.			0	1 (1926)	10007
Subjective measure of political power	Dummy for firms self-rated as most influential on government. WBES question 25.			0	1 (503)	7802
Government ownership	Dummy for whether a firm is government owned. WBES question viii.			0	1 (1019)	9598

Table 4 Probit estimates: Testing national preference and foreign privilege hypotheses

	(1) General business constraint measure:		(2) Specific business constraints in eight areas:							
Dependent variables:	(1a) Tax and regulatory constraint (TXREG4)	(1b) Tax and regulatory constraint (TXREG4)	(2a) Business licensing (BL_REG4)	(2b) Labor (LAB_REG4)	(2c) Environment (ENV_REG4)	(2d) Fire (FIR_REG4)	(2e) High taxes (HIT_REG4)	(2f) Tax administration (TADM_REG4)	(2g) Customs (CUS_REG4)	(12h) Foreign exchange (FRK_REG4)
Foreign firm dummy (FOREIGN)	**-0.17*** (0.05)**	**-0.14*** (0.05)**	**0.01 (0.05)**	**-0.12*** (0.05)**	**-0.22*** (0.06)**	**-0.06 (0.06)**	**-0.17*** (0.04)**	**-0.10*** (0.04)**	**0.05 (0.05)**	**0.02 (0.05)**
Export status dummy	-0.07* (0.04)	-0.06 (0.04)	-0.11*** (0.05)	0.00 (0.04)	0.02 (0.05)	-0.03 (0.05)	-0.07* (0.04)	-0.02 (0.04)	0.15*** (0.04)	0.08* (0.05)
Large firm dummy	-0.19*** (0.05)	-0.20*** (0.05)	0.01 (0.05)	-0.04 (0.05)	-0.04 (0.06)	-0.22*** (0.07)	-0.21*** (0.05)	-0.21*** (0.05)	-0.14 (0.05)	-0.17*** (0.06)
New firm dummy (since 1994)	0.00 (0.04)									
Log value of sales/fixed asset ratios	-0.01 (0.01)									
Industry controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.28 (0.28)	-0.90*** (0.28)	-1.89*** (0.45)	-1.15*** (0.31)	-1.45*** (0.37)	-1.91*** (0.45)	-0.15 (0.23)	-0.95*** (0.30)	-1.91*** (0.38)	-1.18*** (0.30)
No. of observations	6826	8080	8212	8438	7800	7797	8509	8324	7338	7336
Pseudo R^2	0.13	0.17	0.09	0.15	0.07	0.06	0.14	0.12	0.08	0.12

Notes: ***=Significant at 1%; **=Significant at 5%; *=Significant at 10%. Standard errors are in the brackets. All the dependent variable is formulated as the choice of 4 in the given business constraint measure. All the business constraint measures range from 1 to 4, with 1 representing no obstacle and 4 representing most obstacle. In the original WBES dataset, the values of TXREG for some of African countries take on non-integer values between 0.17 and 4. These values have been rounded up and converted into integer values here on a 1-4 scale.

Table 5 Alternative specifications and robustness checks

Explanations:	(1) Firm-invariant dependent variable: Quality of telephone service	(2) Alternative measure of foreign firm status: Foreign equity ratio	(3) Alternative measure of tax and regulatory constraint: TXREG3_4	(4) Alternative measure of tax and regulatory constraint: Original WBES response values of TXREG	(5) Dropping firm-level controls	(6) Dropping industry controls	(7) Dropping country dummies	(8) Only FOREIGN in the regression	(9) Country-level economic variables	(10) Country-level economic and institutional variables	(11) Country-level economic and institutional variables plus country dummies
Statistical models	Probit	Probit	Probit	Ordered probit	Probit	Probit	Probit	Probit	Probit (coefficients clustered on countries)	Probit (coefficients clustered on countries)	Probit
Dependent variables:	QTEL4	TXREG4	TXREG3_4	TXREG	TXREG4	TXREG4	TXREG4	TXREG4	TXREG4	TXREG4	TXREG4
Foreign firm dummy (FOREIGN)	**-0.01 (0.05)**		**-0.07* (0.04)**	**-0.10*** (0.03)**	**-0.18*** (0.04)**	**-0.15*** (0.04)**	**-0.29*** (0.04)**	**-0.42*** (0.04)**	**-0.12*** (0.05)**	**-0.12*** (0.05)**	**-0.14*** (0.05)**
Foreign equity ratio (FER)		**-0.002** (0.001)**									
Country-level variables	No	No	No	No	No	No	No	No	Yes	Yes	Yes
Firm-level controls	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes
Industry controls	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	Yes
Constant	-1.4*** (0.33)	-0.66 (0.66)	-0.39 (0.24)		-0.88*** (0.27)	-1.06*** (0.29)	-0.97*** (0.10)	-0.31*** (0.01)	-0.27 (0.31)	-2.23*** (0.63)	-2.23*** (0.57)
No. of observations	7849	1726	8241	8241	8395	8773	8241	9105	8209	7883	8048
Pseudo R^2	0.17	0.18	0.16	0.10	0.17	0.16	0.03	0.01	0.09	0.12	0.17

Notes: ***=Significant at 1%; **=Significant at 5%; *=Significant at 10%. Robust standard errors are in the brackets. The dependent variable is TEXREG4, except for Regression (1) and (3). Specification (1) has the quality of telephones as the dependent variable; TXREG3_4 in specification (3) is formulated by setting TXREG3_4 to 1 when firms chose the top two constraint scores, i.e., 3 or 4, on the 1-4 scale. TXREG4 is formulated as the choice of the highest value of the business constraint measure on a 1-4 scale. Country-level economic variables are: (1) FDI stock /GDP ratio in 1999, (2) log value of real per capital GDP (1995 dollar) in 1999, (3) real growth of per capita GDP between 1991 and 2000 and (4) ratio of number of sampled foreign firms to the number of sampled domestic firms. Country-level institutional variables are average values of the six KKZ institutional measures in 1997 and 2000. They are (1) control of corruption (CC97_00), (2) rule of law (RL97_00), (3) regulatory quality (RQ97_00), (4) government effectiveness (GE97_00), (5) political stability (PS97_00), and (6) voice and accountability (VA97_00). For regressions (8) and (9), country dummies are omitted and standard errors are clustered on countries to take into account the within-country correlations of firms' perceptions of business environments.

Table 6 Controlling for differences in the business nature between foreign and domestic firms

Explanations:	(8) Controlling for kvetch factor	(9) Controlling for import activities		(10) Controlling for transfer pricing			Controlling for firm-level corruption constraint	
Dependent variables:	TXREG4	TXREG4	TXREG4	TXREG4	HIT_REG4	TADM_REG4	TXREG4	TXREG4
Foreign firm dummy (FOREIGN)	**-0.14*** (0.05)**	**-0.09* (0.05)**	**-0.16*** (0.05)**	**-0.13*** (0.05)**	**-0.16*** (0.05)**	**-0.10** (0.05)**	**-0.15*** (0.05)**	**-0.16*** (0.05)**
% sales changes in last 3 years	-0.001*** (0.000)							
Import clearance days		0.0002* (0.001)						
Customs/foreign trade regulations (CUS_REG)			0.17*** (0.02)					
Dummy for operations in other countries				-0.08 (0.05)	-0.11*** (0.05)	0.01 (0.05)		
Exchange rate as a general constraint				0.23*** (0.02)	0.18*** (0.02)	0.16*** (0.02)		
Voices of firms with government							0.12*** (0.02)	
Time spent with government officials								0.07*** (0.01)
Firm-level controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-0.79*** (0.37)	1.2*** (0.59)	-1.3*** (0.32)	-0.44* (0.26)	-0.32 (0.26)	-0.61*** (0.26)	-1.42*** (0.33)	-1.02*** (0.32)
No. of observations	5895	4997	6858	7495	7609	7561	6873	7166
Pseudo R^2	0.17	0.16	0.18	0.19	0.16	0.13	0.15	0.16

Notes: ***=Significant at 1%; **=Significant at 5%; *=Significant at 10%. Robust standard errors are in the brackets. The dependent variable is TEXREG4, except for specifications (1) and (3). For regression (10), the additional firm-level control included is the percentage change in sales of firms between 1997 and 1999. Country-level variables (3) include all the variables in Country-level variables (2) plus additional firm controls (a dummy variable denoting whether the firm has operations in other countries and perception of exchange rate as a business constraint).

Table 7 Political power of domestic firms and foreign privilege: Two measures of political power of domestic firms

Panel (1): Foreign firms are benchmarked against politically-powerful domestic firms:	*(1a) Domestic firms with government ownership*				*(1b) Domestic firms self-rated as influential on government*			
Dependent variables:	*TXREG4*	*LAB_REG4*	*HIT_REG4*	*CUS_REG4*	*TXREG4*	*LAB_REG4*	*HIT_REG4*	*CUS_REG4*
Foreign firm dummy (FOREIGN)	**-0.03 (0.08)**	**0.03 (0.10)**	**0.02 (0.08)**	**0.16 (0.10)**	**0.02 (0.09)**	**0.01 (0.10)**	**0.12 (0.08)**	**0.25*** (0.11)**
Firm-level controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry and country dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-1.08* (0.61)	-1.06* (0.64)	-0.75 (0.52)	-0.63 (0.45)	-1.03 (0.64)	-0.89 (0.64)	0.63 (0.68)	-0.93 (0.64)
No. of observations	2296	2132	2526	2115	1841	1646	2052	1724
Pseudo R^2	0.17	0.14	0.17	0.12	0.17	0.11	0.15	0.11
Panel (2): Foreign firms benchmarked against politically-powerless domestic firms	*(2a) Domestic firms without government ownership*				*(2b) Domestic firms self-rated as lacking in influence on government*			
Foreign firm dummy (FOREIGN)	**-0.16*** (0.05)**	**-0.13*** (0.05)**	**-0.21*** (0.04)**	**0.03 (0.05)**	**-0.19*** (0.05)**	**-0.17*** (0.06)**	**-0.21*** (0.05)**	**0.05 (0.06)**
Firm-level controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry and country dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-0.72*** (0.27)	-1.51*** (0.47)	-0.19 (0.24)	-2.17*** (0.45)	0.58 (0.48)	-1.06** (0.55)	-0.28 (0.51)	-1.08** (0.59)
No. of observations	7116	7400	7556	6453	6691	6747	6947	5815
Pseudo R^2	0.17	0.14	0.14	0.08	0.14	0.15	0.14	0.07

Notes: ***=Significant at 1%; **=Significant at 5%; *=Significant at 10%. Robust standard errors are in the brackets. The subjective measure of political power comes from Question (25) in the WBES, "In case of important changes in laws or policies affecting my business operation the government takes into account concerns voiced either by me or by my business association." The response is given on a 1-6 point scale with one indicating the strongest influence on governments and six indicating none. A politically-connected domestic firm is coded as 1 if it scored 1 or 2 on this six-point scale and 0 otherwise.

Table 8 Poor institutional contexts and business constraints: Foreign vis-à-vis foreign firms

	Country-average TXREG scores by foreign and domestic firms		*Countries marked with X are at the bottom 25% in the WBES on the following four KKZ institutional measures: 1) control of corruption, 2) government effectiveness, 3) voice and accountability, and 4) rule of law.*			
Countries/Firms	*Foreign firms*	*Domestic firms*	*1) Control of corruption*	*2) Government effectiveness*	*3) Voice and accountability*	*4) Rule of law*
Albania	2.57	3.14	X			X
Armenia	2.0	3.47	X			
Azerbaijan	3.0	2.98	X		X	
Bangladesh	2.8	2.97				X
Belarus	3.0	3.35		X	X	X
Bosnia	3.08	3.33		X	X	X
Cambodia	2.45	2.14			X	
Cameroon	2.76	2.71	X		X	X
China	1.94	2.15			X	
Colombia	3.11	3.12				X
Cote I'voire	2.56	2.83			X	
Ecuador	2.75	3.15	X	X		X
Egypt	3.63	3.42			X	
Ethiopia	2.5	2.43			X	
Georgia	2.89	3.41		X		
Guatemala	2.68	2.77	X			X
Haiti	2.45	2.91		X	X	X
Honduras	2.53	2.81	X			X
Indonesia	2.56	2.54	X		X	X
Kenya	2.69	2.78	X	X	X	X
Kyrgyzstan	3.63	3.53	X	X		
Kazakhstan	3.43	3.23	X	X	X	
Madagascar	3.18	2.86				X
Malawi	2.31	2.30		X		
Moldova	3.5	3.48		X		
Nicaragua	2.71	3.06	X	X		X
Nigeria	2.8	2.80	X	X	X	X
Pakistan	3.13	3.25	X	X	X	X
Russia	3.2	3.53	X	X		X
Tanzania	2.8	2.77				
Tunisia	2.22	2.16			X	
Turkey	3.42	3.08			X	
Uganda	2.68	2.64			X	
Ukraine	3.5	3.67	X	X		
Uzbekistan	2.59	2.61	X	X	X	X
Venezuela	3.12	3.08		X		X
Zambia	2.83	2.65	X			
Zimbabwe	2.87	3.29		X	X	
Group average TXREG scores	2.84	2.97	Foreign: 2.80 Domestic:3.21	Foreign: 2.87 Domestic: 3.29	Foreign: 2.67 Domestic: 2.84	Foreign: 2.82 Domestic: 3.14

Notes: Institutionally underdeveloped countries are those that are ranked below 25 percentile of the WBES countries on the KKZ institutional measures. KKZ provided data for two years, 1997 and 2000. Data used in this table are the average values of these two years. The cutoff point for the control of corruption value (CC97_00) is -0.756. The mean value of CC97_00 is -0.12 and the maximum and minimum values are, respectively, +2.15 and -1.11. The cutoff point for the government effectiveness measure (GE97_00) is -0.585. (Mean value=-0.07; maximum value=2.12 and minimum value=-1.28). The cutoff point for the voice and accountability measure (VA97_00) is -0.45. (Mean value=0.13; maximum value=1.63 and minimum value=-1.23.) In the WBES, some of values for TXREG are non-integer. They have all been rounded up into integer values here.

Table 9 Institutional contexts and foreign privilege: Dependent variable==TXREG4

Panel (1): Institutional dummy for countries in WBES ranked at or below 20th on the following three KKZ measures: 1) control of corruption, 2) government effectiveness and 3) regulatory quality									
	(1) Control of corruption			(2) Government effectiveness			(3) Regulatory quality		
	(1a) Country dummies	(1b) Country-level variables	(1c) Excluding institutional dummy	(2a) Country dummies	(2b) Country-level variables	(2c) Excluding institutional dummy	(3a) Country dummies	(3b) Country-level variables	(3c) Excluding institutional dummy
Foreign firm dummy (FOREIGN)	**-0.094** (0.05)**	**-0.04 (0.05)**	**-0.08 (0.05)**	**-0.11** (0.05)**	**-0.05 (0.05)**	**-0.09* (0.05)**	**-0.11** (0.05)**	**-0.06 (0.05)**	**-0.08 (0.05)**
FOREIGN & institutional dummy interaction term (FOR_INST)	**-0.22*** (0.11)**	**-0.40*** (0.10)**	**-0.23** (0.13)**	**-0.13 (0.11)**	**-0.32*** (0.08)**	**-0.14 (0.11)**	**-0.12 (0.11)**	**-0.29*** (0.09)**	**-0.19* (0.11)**
Panel (2): Institutional dummy for countries in WBES ranked at or below 20th on the following three KKZ measures: 4) rule of law, 5) political stability and 6) voice and accountability									
	(4) Rule of law			(5) Political stability			(6) Voice and accountability		
	(4a) Country dummies	(4b) Country-level variables	(4c) Excluding institutional dummy	(5a) Country dummies	(5b) Country-level variables	(5c) Excluding institutional dummy	(6a) Country dummies	(6b) Country-level variables	(6c) Excluding institutional dummy
Foreign firm dummy (FOREIGN)	**-0.12** (0.05)**	**-0.08 (0.05)**	**-0.11* (0.06)**	**-0.16*** (0.05)**	**-0.10** (0.05)**	**-0.10* (0.06)**	**-0.18*** (0.05)**	**-0.13** (0.05)**	**-0.09* (0.05)**
FOREIGN & institutional dummy interaction term (FOR_INST)	**-0.08 (0.11)**	**-0.16 (0.12)**	**-0.06 (0.15)**	**0.09 (0.11)**	**-0.08 (0.13)**	**-0.08 (0.15)**	**0.19* (0.11)**	**0.05 (0.11)**	**-0.13 (0.13)**
The following control variables appear in both Panel (1) and (2) regressions.									
Institutional dummy	Yes	Yes	No	Yes	Yes	No	Yes	Yes	No
Firm-level controls and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country dummies	Yes	No	No	Yes	No	No	Yes	No	No
Country-level variables	No	No	Yes	No	No	Yes	No	No	Yes

Notes: ***=Significant at 1%; **=Significant at 5%; *=Significant at 1%. Robust standard errors are in the brackets. The dependent variable is TEXREG4. Country-level economic variables are: (1) FDI stock /GDP ratio in 1999, (2) log value of real per capital GDP (1995 dollar) in 1999, (3) real growth of per capita GDP between 1991 and 2000 and (4) ratio of number of sampled foreign firms to the number of sampled domestic firms. For regressions that used country-level variables in lieu of country dummies, the standard errors are clustered on countries to take into account the within-country correlations of firms' perceptions of business environments.

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