What influence the choice of host country in Chinese firm cross-border M&As on culture distance, institution and tax

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Abstract: What influence the choice of host country when Chinese firm make cross-border merger and acquisitions (M&A)? According to 1,051 Chinese cross-border M&A transactions in the years 2000–2015 listed in BVD-Zephyr database, we find that culture distance, institution and tax are the three most significant factors: 1) Chinese firms are more likely to choose host country with close culture when conduct cross-border M&As. 2) Chinese firms tend to choose M&A method to enter countries that have stronger institutions. Among the six specific institution factors (control of corruption, government effectiveness, political stability, regulatory quality, rule of law, voice and
accountability), Chinese firms care more about control of corruption, government effectiveness, political stability and regulatory quality. 3) Low-tax countries are more attractive to Chinese firm cross-border M&As.

Keywords: cross-border merger and acquisition; culture distance; institution and tax.


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1 Introduction

Although numerous studies analyse mergers and acquisitions (M&As) by developed economies, M&As by emerging economies have been receiving increasing attention from scholars (Peng, 2012; Young et al., 2014). Firms based in emerging economies have not only been undertaking M&As within these rapidly developing economies, but also have been increasingly active in undertaking M&As outside of their domestic markets (Meyer and Thajjongkrak, 2013). For example, Chinese firms have recently begun international expansion in a significant way. Chinese cross-border M&As have also grown sharply in recent years, for example by 345% between 2005 and 2015 (BVD database). The international business literature points to some factors that influence the developed economies international expansion of firms, market size, natural resource, low cost, knowledge asset (Buckley et al., 2007; Dunning, 1998) and geography distance. Recent international expansion of emerging economies, especially China, deserves greater
What influence the choice of host country in Chinese firm cross-border research attention since features of such expansion that are particularly prominent or different can help advance extant theory (Cuervo-Cazurra, 2012; Luo and Tung, 2007). As a developing country, China has significant different culture and institution compared with developed economies.

We focus on the choice of destination in the international expansion behaviour of developed economies. We argue that there is a negative relationship between the cultural distance and the number of cross-border M&As by Chinese firms. There is a positive relationship between institution level of host countries and the number of cross-border M&As by Chinese firms. And the relationship between tax rates of host countries and the number of cross-border M&As by Chinese firms is negative. According to 1,051 Chinese cross-border M&A transactions in the year 2000–2015 listed in BVD-Zephyr database, we use empirical method to test the relationship between cross-border M&A, culture distance (CD), institution and tax.

The first innovation is this research considered more about the institution level of host countries. At the process of cross-border M&As, the company must reduce the uncertainty. So, the institution level of host countries can be seen as a method of reduce the uncertainty of local environment. This research gives out a new method to control the host country’s environment. The second innovation is deriving from the introduction of the tax rate to the cross-border M&A. Prior researches ignore the burden of tax for the company at the process of cross-border M&A, so this research innovatively considered the tax rate influence the decision of cross-border M&A.

Our study makes two contributions. Firstly, we enrich the institutions based view of international business to explain the phenomenon of the situation of cross-border M&As, which is extends the boundaries of this principle. Second, we introduce the tax rate to the research of cross-border M&As, which gives a new view of host countries’ environments.

2 Literature review

In traditional international business literature, there are four factors that influence the international expansion of firms: market size, natural resource, low cost and knowledge asset (Buckley et al., 2007; Dunning, 1998; Chari and Acikgoz, 2016). Numerous studies have shown that the size of a country market (typically measured as the country’s GDP) is an important factor attracting foreign firm investments (Buckley et al., 2007). The access to some important natural resource is another significant factor for firms international expansion (Buckley et al., 2007). Cutting costs is a way to increase the profits of the firms, so get access to low labour costs countries is another motivation for international expansion (Dunning, 1998). Bevan and Estrin (2004) found higher labour costs and foreign investment were negatively correlated. Knowledge assets tend to be embedded in employees and organisations, and as tacit assets, they are less amenable to arms-length transfer (Kogut and Zander, 1993). Firms acquire either parts or the whole of firms in host countries that possess these assets to seek knowledge in their international expansion (Buckley et al., 2007).

International expansion by emerging economy (EE) firms has grown rapidly in the past decade, and cross-border M&As have been a prominent vehicle for such expansion
Empirical studies show that, similar to AE firms, traditional motivations also appear to drive EE firm internationalisation (Buckley et al., 2007, 2012). Recently, scholars focus more on how CD institutions and tax affect cross-border M&As.

Culture is defined as a kind of shared values that are transferred through socialisation to offer behavioural rules among its members (Tabellini, 2008). Cultural distance increase the attractiveness of the firm’s stock to host market investors which can influence the choice of cross-border M&As. Barkema and Vermeulen (1997) argued that cultural differences make barriers to the flow of information, that seems to make interprets relevant information accurately difficult and finally reduce investors’ willingness. Furthermore, Beugelsdijk and Frijns (2010) do empirical research found that the correction between investors’ willingness to invest in a foreign market and cultural distance was negative. Sarkissian and Schill (2004) argue that managers’ believe that investors are less willing to invest in unfamiliar firms. Accordingly, CD possibly hamper performance in M&A integration.

Institutions are salient determinants of cross-border M&As (Hoskisson et al., 2013; Luo and Tung, 2007; Meyer et al., 2009; Meyer and Thajjongrak, 2013; Peng and Parente, 2012). Weaker institutions means a degree of uncertainty, as well as a lack of transparency and contract enforcement. Because of this, transaction costs of cross-border M&As including due diligence, negotiations, and post-acquisition integration are higher in weaker institutions (Sun et al., 2012). Meyer et al. (2009), in a cross-country study (which includes Egypt, India, South Africa, and Vietnam), argue that foreign firms are more likely to choose acquisition or greenfield method to enter a countries when they have stronger market-supporting institutions. Li and Qian (2013) argue that the stronger institution provides better protection of shareholders’ rights. And this can also reduce the conflict between controlling and minority shareholders (Young et al., 2008). Li and Qian’s (2013) empirical analysis find that the level of provincial institutional development positively moderates the negative influence of the degree of control (equity share) of the largest shareholder on the probability of an acquisition.

Lowering taxes is another motivation for international expansion. The transfer of an asset between two owners who are taxed differently will generates taxable income (Becker and Fuest, 2010). Boddevy and Brewer (1994) cite the ‘escape is an expression of avoidance’ view as a ‘vote by foot’ corporate political action. Caves (1996), based on previous research, argues that certain factors in the country, such as high tax rates, increase FDI. Altshuler and Grubert (2001) find that a one-percentage point increase in the local tax rate reduces the FDI stock between 0.1% and 2.8%. Gordon and Hines (2002) reviewed the study of international taxes and found that firms would relocate their headquarters to escape from their high tax rates. Huizinga and Voget (2009) have shown that the likelihood of a parent firm locating in a given country following a cross-border M&A is reduced by high international double tax of foreign source income.

The main research streaming on cross-border M&As within the existing literature are performance and integration as well as their influence factors, lack of research on the choice of target countries. We contend that while traditional motivations apply to international expansion. There are more important motivations influence the choice of host country when Chinese firm make cross-border merger and acquisitions (M&A). So we argue that CD, institution and tax have great impact on host country choices when Chinese firms take cross-border M&As.
3 Hypotheses

3.1 CD and cross-border M&As

Cultural distance becomes more and more important when firms decide to make cross-border M&As. Actually, many studies find that cultural distance hinders post-merger integration and cause acquisition failures (Daniel and Metcalf, 2001). Nearly half of acquisition failures are caused by difficulty cultures integration (Doney et al., 1998). Cultural distance between the host and the home country increases transaction costs, including due diligence, negotiations, the costs of adaptation, integrate people, handling of inter-firm conflict, performance monitoring, information sharing and transfer of strategic resources, thus reducing firm value (Chatterjee et al., 1992; Li and Guisinger, 1992). Furthermore, cultural differences increase levels of risk and cause executives’ uncertainty about their cross-border operations (Gatignon and Anderson, 1988). These culture differences cause difficulty in understanding partners’ languages, values, and non-verbal cues, which lowers sentiment and trust between the members (Le and Evangelista, 2007).

In the process of integration, national culture that made the differences in traditions, character, values and attitudes cause conflict when members respond to problems (Barkema et al., 1996). And even lead to negative attitudes towards M&As, reduced cooperation, reduced responsibility and frustrated management (Krug and Hegarty, 2001), thus hampering the effective interaction between the two firms (Mohr and Spekman, 1994; Ring and Vande Ven, 1994; Sirmon and Lane, 2004; Pothukuchi et al., 2002) and ultimately leads to poor integration performance. In recent years, Chinese firms investment structure is becoming more diversified, expanding from the emerging economies in Latin America and Asia to Europe, North America and other mature markets. One of the most important things when Chinese enterprises open up new markets abroad is adapting to the local social environment quickly and flexibly. Empirical literature also shows that Chinese cross-border M&As performance is significantly higher between close cultural than long cultural distance. Thus:

Hypotheses 1 There is a negative relationship between the cultural distance (between China and the host country) and the number of cross-border M&As by Chinese firms.

3.2 Institution and cross-border M&As

Institution is important to maintain market stability and security. La Porta et al. (1999) argues that laws and regulations are more protective of investors in countries where the justice institution is more robust. A strong judicial institution protects the rights of investors, especially small and medium-sized investors and further reduces default risk and transaction costs. In addition, political stability provides a fair and secure environment for market participants. Low political stability reflecting a lack of social stability, which increases the risk of investment in the host country and discourages Chinese firms cross-border M&As. Noorbakhsh et al. (2001) found that political violence and terrorism in the host country slowed the entry of FDI.

In terms of government efficiency, Globerman and Shapiro (2002) studied 1995–1997 sample of both developed and developing countries and found that
government efficiency is an important determinant of FDI inflows and outflows. Firstly, government’s high efficiency of the host country can provide comprehensive and effective public services, so as to support the development of foreign-funded enterprises. Secondly, efficient government means that foreign investment in the host country will face fewer constraints and political pressures, investment income is more predictable, and thus also contributed to the inflow of Chinese cross-border M&As. Thus:

Hypotheses 2 There is a positive relationship between institution level of host countries and the number of cross-border M&As by Chinese firms.

3.3 Tax and cross-border M&As

In order to achieve profit maximisation, firms would try to reduce their taxes. The tax in the host country covers the firms income tax rate, the total tax rate and tax avoidance and so on. If the host country’s tax rate is high, the cost of foreign operations will increase, which will reduce the investment profits. Countries vary in their tax rates, and firms can lower their taxes by expanding into a country with lower tax rates. There is a negative association between the tax rate of host country and the likelihood of cross-border M&A into the host country. Therefore, we expect Chinese companies are more likely to invest in low-tax countries and regions. Thus:

Hypotheses 3 There is a negative relationship between tax rates of host countries and the number of cross-border M&As by Chinese firms.

4 Methods

4.1 Data

We obtain data on Chinese cross-border M&As from the year 2000-2015 listed in BVD-Zephyr database which has been used extensively in prior research. And then processing the data in accordance with the following filter conditions:

1 Each transaction at least one of the promoters is Chinese mainland enterprises.

2 Acquisition targets must be registered companies outside of China, dropping these of Hong Kong, Taiwan and Macao.

3 The transaction status is complete.

4 Dropping indicator variables missing data samples.

The matching results in a sample of 1,051 Chinese cross-border M&As and target firms from 84 countries and regions. And 32.7% of the acquisitions are in tax havens.

4.2 Model

We estimate a logistic regression model of the following general form to test our hypotheses.
DC\textsubscript{t} = a_0 + a_1 \text{Culture distance}_t + a_2 \text{Institution}_t + a_3 \text{Tax rate}_t \\
+ a_4 \text{Market size}_t + a_5 \text{Natural resource}_t + a_6 \text{Labor cost}_t \\
+ a_7 \text{Knowledge asset}_t + a_8 \text{Geography distance}_t \\
+ a_9 \text{Industry}_t + \epsilon_t

The subscript \( t \) represents year. The dependent variable \( DC\textsubscript{t} \) indicates whether or not the country of the target firm is a developed country (DC) and takes a value of one if the target firm is a DC and zero otherwise. We control for market size, natural resources, labour cost, knowledge assets, tax rate and geography distance. In addition, we control for the year and whether the acquiring firms and target firms are the same industry (takes a value of one if they are the same and zero otherwise).

4.3 Variables

Whether or not the country of the target firm is a DC is our dependent variable. We code this variable 1 if the target firm is in one of the 80 countries and territories widely regarded as high income, using data from the world development indicators (WDI) database and zero otherwise.

We measure CD using Hofstede’s (1980, 2001) culture scores which have been used widely in empirical research. Hofstede (1980, 2001) developed six cultural dimensions: uncertainty avoidance, individualism, power distance, masculinity, long-term orientation and indulgence. We use Mrosini and Singh’s (1998) method to compute a measure of cultural distance between countries. \[ CD = \sqrt{\sum_{k=1}^{4} (I_d - I_m)^2} . \] And we improve the above formulate by using six cultural dimensions. If the host country is not in the list of the data provided in Hofstede site, we take their recent economy dimension data according to Google Maps location.

We measure institution using data on country governance collected by the World Bank. The country governance data pertain to six areas of formal institutions – control of corruption, government effectiveness, political stability, regulatory quality, rule of law, voice and accountability – and have been used extensively to measure a country’s institutional strength (Slangen and Beugelsdijk, 2010). Following prior literature, we average the scores on the six areas as our measure of institutional strength (Slangen and Beugelsdijk, 2010). Higher values on the measure indicate greater institutional strength.

We measure corporate tax rate as the corporate tax rate in the host country, using data from KPMG.

We measure country market size as the gross domestic product of the country in trillions of US dollars, using data from the WDI database (Buckley et al., 2007). The control variable natural resources, which represents the host country’s comparative advantage in natural resources, is measured as the ratio of ore and metal exports to merchandise exports of the host country using data from WDI (Buckley et al., 2007). Labour cost in the host country is measured as the minimum wage in the host country in PPPS using data from the International Labour Organization. Knowledge assets in the host country are measured as the number of US patents in thousands granted to entities from the host Country, with data from the US patent office (Chang et al., 2006). We use the number of US patents rather than patent filings in the host country to control for variability in patent laws across countries (Chang et al., 2006). Geographic distance
between the home and host country is measured in thousands of kilometres with data from CEPII (Mayer and Zignago, 2011). We use a dummy variable that takes a value of 1 if the acquiring firms and target firms are the same industry and zero otherwise. According to four-digit SIC code, if the first two digits are the same, then they are the same industry.

4.4 Results

Table 1 shows the distribution of Chinese overseas acquisitions (COA) by host country. British Virgin Islands, US and Cayman Islands are the three countries and territories with the most numbers of COAs in the sample. And of the top 20 countries, six are tax havens (British Virgin Islands, Cayman Islands, Singapore, Bermuda, Netherlands and Panama).

<table>
<thead>
<tr>
<th>Country name</th>
<th>Amounts of deals</th>
<th>Country name</th>
<th>Amounts of deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Virgin Islands</td>
<td>141</td>
<td>Netherlands</td>
<td>27</td>
</tr>
<tr>
<td>US</td>
<td>125</td>
<td>Italy</td>
<td>20</td>
</tr>
<tr>
<td>Cayman Islands</td>
<td>113</td>
<td>Japan</td>
<td>20</td>
</tr>
<tr>
<td>Germany</td>
<td>91</td>
<td>Panama</td>
<td>16</td>
</tr>
<tr>
<td>Singapore</td>
<td>44</td>
<td>Brazil</td>
<td>15</td>
</tr>
<tr>
<td>UK</td>
<td>42</td>
<td>Thailand</td>
<td>13</td>
</tr>
<tr>
<td>Australia</td>
<td>37</td>
<td>Spain</td>
<td>11</td>
</tr>
<tr>
<td>France</td>
<td>35</td>
<td>Indonesia</td>
<td>10</td>
</tr>
<tr>
<td>Bermuda</td>
<td>33</td>
<td>Korea, Rep.</td>
<td>10</td>
</tr>
<tr>
<td>Canada</td>
<td>27</td>
<td>Malaysia</td>
<td>10</td>
</tr>
</tbody>
</table>

Table 2 shows maxes, mins, means, p50 and standard deviations. The mean of developed countries is 0.83, shows that developed countries hold dominant position in COA. We also did correlation Analysis. The correlation between host country CD and host country institution is very high. We therefore do not use the two variables together in the same model.

<table>
<thead>
<tr>
<th></th>
<th>max</th>
<th>min</th>
<th>mean</th>
<th>p50</th>
<th>Sd</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed country</td>
<td>1.00</td>
<td>0.00</td>
<td>0.83</td>
<td>1.00</td>
<td>0.37</td>
<td>1,051</td>
</tr>
<tr>
<td>Culture distance</td>
<td>2.01</td>
<td>0.97</td>
<td>1.92</td>
<td>1.98</td>
<td>0.15</td>
<td>1,051</td>
</tr>
<tr>
<td>Institution</td>
<td>1.88</td>
<td>-1.56</td>
<td>0.96</td>
<td>1.14</td>
<td>0.66</td>
<td>1,051</td>
</tr>
<tr>
<td>Market size</td>
<td>12.10</td>
<td>1.44</td>
<td>7.48</td>
<td>8.31</td>
<td>3.36</td>
<td>1,051</td>
</tr>
<tr>
<td>Resource</td>
<td>86.42</td>
<td>0.00</td>
<td>4.86</td>
<td>2.57</td>
<td>10.01</td>
<td>1,051</td>
</tr>
<tr>
<td>Tax rate</td>
<td>137.40</td>
<td>0.01</td>
<td>31.24</td>
<td>34.30</td>
<td>24.01</td>
<td>1,051</td>
</tr>
<tr>
<td>Knowledge assets</td>
<td>14.92</td>
<td>0.00</td>
<td>8.71</td>
<td>9.22</td>
<td>4.05</td>
<td>1,051</td>
</tr>
<tr>
<td>Labour cost</td>
<td>7.43</td>
<td>2.64</td>
<td>6.88</td>
<td>7.27</td>
<td>0.81</td>
<td>1,051</td>
</tr>
<tr>
<td>Geographic distance</td>
<td>9.87</td>
<td>6.86</td>
<td>9.09</td>
<td>9.13</td>
<td>0.51</td>
<td>1,051</td>
</tr>
</tbody>
</table>
Table 3 shows hypotheses test results. Model 1 is the base model and includes the control variables and tax independent. Models 2 to 4 show results when we add each independent variable of interest to model 1. All of the models have significant chi2 values, and a likelihood ratio test shows that including the variables of interest significantly enhances model fit. The coefficient of host country CD is significant and negative in model 2, supporting Hypotheses 1. The coefficient of host country Institution is significant and positive in model 3, supporting Hypotheses 2. Furthermore, in model 4, we analyse the six specific institution factors, control of corruption, government effectiveness, political stability, regulatory quality, rule of law, voice and accountability. The coefficient of host country control of corruption, government effectiveness, political stability and regulatory quality is significant and positive in model 4. And in all four models, the coefficient of host country tax rate is significant negative, supporting Hypotheses 3.

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture distance</td>
<td>–53.41*** (–5.75)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institution</td>
<td>13.12*** (4.34)</td>
<td>18.99*** (2.72)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control of corruption</td>
<td></td>
<td>–13.85** (–2.55)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government effectiveness</td>
<td></td>
<td></td>
<td>7.938*** (3.03)</td>
<td></td>
</tr>
<tr>
<td>Political stability</td>
<td></td>
<td></td>
<td></td>
<td>6.086** (2.15)</td>
</tr>
<tr>
<td>Regulatory quality</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rule of law</td>
<td></td>
<td></td>
<td>1.929 (0.63)</td>
<td></td>
</tr>
<tr>
<td>Voice and accountability</td>
<td></td>
<td>–0.796 (–0.46)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>–0.0725*** (–3.76)</td>
<td>–0.0734*** (–4.07)</td>
<td>–0.14** (–2.29)</td>
<td>–0.319*** (–2.67)</td>
</tr>
<tr>
<td>Market size</td>
<td>–0.917*** (–3.64)</td>
<td>–0.370 (–1.33)</td>
<td>–0.66 (–2.12)</td>
<td>0.539 (0.71)</td>
</tr>
<tr>
<td>Resource</td>
<td>0.00113 (0.05)</td>
<td>0.0164 (0.83)</td>
<td>–0.18*** (–3.05)</td>
<td>–0.385*** (–3.15)</td>
</tr>
<tr>
<td>Knowledge assets</td>
<td>1.470*** (6.73)</td>
<td>1.176*** (5.03)</td>
<td>1.56*** (2.74)</td>
<td>2.870*** (3.01)</td>
</tr>
<tr>
<td>Labour cost</td>
<td>1.536*** (4.00)</td>
<td>11.86*** (5.90)</td>
<td>–0.57 (–1.16)</td>
<td>–0.615 (–0.49)</td>
</tr>
<tr>
<td>Geographic distance</td>
<td>1.349** (2.28)</td>
<td>1.125* (1.8)</td>
<td>3.75*** (2.59)</td>
<td>5.654** (2.4)</td>
</tr>
<tr>
<td>Industry dummies</td>
<td>–0.608 (–1.22)</td>
<td>–1.325*** (–2.22)</td>
<td>–0.71 (–0.64)</td>
<td>–3.547 (–1.63)</td>
</tr>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>_cons</td>
<td>–8.88</td>
<td>24.55</td>
<td>–17.83</td>
<td>–56.54</td>
</tr>
<tr>
<td>Chi2</td>
<td>776.6</td>
<td>810.6</td>
<td>893.42</td>
<td>913.2</td>
</tr>
<tr>
<td>R²</td>
<td>82.1%</td>
<td>85.6%</td>
<td>94%</td>
<td>96.5%</td>
</tr>
<tr>
<td>N</td>
<td>1,051</td>
<td>1,051</td>
<td>1,051</td>
<td>1,051</td>
</tr>
</tbody>
</table>

Notes: Parenthesis is the value of t. * means p < 0.1, ** means p < 0.05, ***means p < 0.01.
5 Conclusions and suggestion

5.1 Conclusion

Our study shows that Chinese firms are more likely to choose culture close host country when conduct cross-border M&As. Chinese firms tend to choose M&A method to enter countries when they have stronger institutions. And among the six specific institution factors, Chinese firms care more about control of corruption, government effectiveness, political stability and regulatory quality. Rule of law, voice and accountability are not concerned very much and this may indicate that China’s cross-border M&AS has a comparative advantage in the absence of a legal system. Furthermore low-tax countries are more attractive to Chinese firm cross-border M&As.

5.2 Suggestion

Our research shows that lowering corporate tax rates and strengthening institutions are two levers to attract investment. With regard to tax levers, lower tax rates also lead to tax losses, so policymakers should seek the best balance. Some of the measures are the collection of more liquidity and activity revenues at a lower tax rate and distinguishing between revenue from domestic operations and foreign operations. With regard to strengthening institutions, our research adds to the cumulative evidence that policymakers can expect to benefit from enhancing the institutions. Successful institutional change depends not only on changes in formal rules, but also on the evolution of informal norms that supplement and expand new formal rules and the efficiency of supervisory institutions, the implementation of new formal rules. It takes time for the supervisory authority to become effective only through the learning process. Therefore, policy-makers seeking to strengthen their institutions must anticipate and prepare for a gradual and slow process.

(Figures:5304).

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