World Development Vol. 78, pp. 341–359, 2016
0305-750X/© 2015 Elsevier Ltd. All rights reserved.
www.elsevier.com/locate/worlddev
http://dx.doi.org/10.1016/j.worlddev.2015.10.001

Effects of FDI Flows on Institutional Development: Does It Matter Where the Investors are from?

FIRAT DEMIR*
University of Oklahoma, Norman, USA

Summary. — Global FDI flows to and from developing countries have increased significantly since the 1990s. While developing countries saw this as a positive development, many economists and policy makers in developed countries have raised concerns regarding the institutional effects of developing country investments in other developing countries. In this paper we explore the effects of bilateral FDI flows on institutional development gaps between countries and whether such effects are conditional on the direction of flows including South–South, South–North, North–South, and North–North directions. The empirical results using bilateral flows between 134 countries and a variety of institutional development measures during 1990–2009 suggest that the institutional development effects of FDI flows in any direction including the North–South or South–South directions are not significant. In any case we do not find any significant convergence or divergence effect of FDI flows on the institutional distance between host and home countries. We also fail to find any significant effect of aggregate North–South FDI flows on host country institutions. In contrast, we find that aggregate South–South FDI flows have a significantly negative effect on host country institutions. Furthermore, we find some evidence that South–South FDI flows may be harmful to institutional development in natural resource-rich countries while the opposite is true for North–South flows. Overall, the results suggest that there is no strong evidence of any benevolent or malevolent effects of bilateral FDI flows from developed or developing countries to developing countries.

Key words — institutional development, conditionality, bilateral FDI flows, South–South economic integration

1. INTRODUCTION

> "What we have here – in states like China, Iran, Saudi Arabia, and Venezuela – are regimes that have the cash and the will to reshape the world into a place very different from where the rest of us want to live. Although they are not acting in concert, they collectively represent a threat to healthy, sustainable development... If they continue to succeed in pushing their alternative development model, they will succeed in underwriting a world that is more corrupt, chaotic, and authoritarian".
>
> [Naím, 2007]

> ``As the beneficiaries of the blessings of a stable democracy and a robust economy, we, as Americans, have an obligation to ensure that our corporations – and their officers, directors, and employees – are not undermining the promise of democracy and economic development in other parts of the world by paying bribes".
>
> [Deputy Attorney General James M. Cole, 2013]

Foreign Direct Investment (FDI) flows to and from developing countries (i.e., the South) have reached \$886 and \$553 billion in 2013, accounting for 61% and 39% of global flows, respectively. Equally impressive has been the fact that for the first time in 2010 Chinese outward FDI flows exceeded those of Japan, reaching \$69 billion in 2010 (and \$101 billion in 2013) (UNCTAD, 2015). Furthermore, within aggregate flows to and from the South, South–South FDI flows reached 63% of all outflows from developing countries in 2010 (UNCTAD, 2011). As FDI has become a significant source of investment and capital formation, there has been a global gold rush in many countries to improve and harmonize their institutional environments in order to strengthen their competitiveness. During 2000–12 alone, an average of 55 countries adopted a total of 1,082 institutional policy changes to promote and facilitate a more favorable environment for foreign investors. Likewise, by the end of 2013 a total of 9,175 bilateral investment treaties including features for improving and re-aligning institutional settings of host and home countries have been signed among 201 countries (UNCTAD, 2014).

The growing importance of developing country multinationals in cross-border investments has also created a controversy regarding their impacts on host country institutions. Particularly, Southern investors are often accused of undermining developed country efforts to improve institutional development in the developing world. While how exactly this happens is not very clear, one channel frequently cited in the press is the lower levels of conditionality involved in South–South economic exchanges, which allegedly diminishes Northern countries' (i.e., the North) bargaining position for institutional and political change in those countries. China, for example, is often criticized for "neglecting human rights offences..., supporting corrupt authoritarian regimes, and undermining Western efforts in these countries to promote good governance" and better economic and political institutional infrastructure (Economist, 2006; Lyman, 2005; Warmerdam, 2012). In addition, Southern investments are argued to have weaker "demonstration" and "professionalization" spillover effects on host country firms and institutions than Northern investments (Kwok & Tadesse, 2006). [1]

Despite the controversy, however, there is no empirical study that tests the "China" *vs.* "Western" effect on developing country institutions. While most research on FDI flows focus on their direct economic effects through technology

* I thank Mustafa Caglayan, Tatiana Didier, Amitava K. Dutt, Kevin Gallagher, Ilene Grabel, Jeffrey B. Nugent, Arslan Razmi, Jaime Ros, the session participants at the ASSA 2014 meeting in Philadelphia, the seminar participants at Koç University, and the World Bank, and the Editor and the three referees of the journal for their comments and suggestions. I thank Xiaoman Duan, Chenghao Hu, Xiaokai Li, and Ying Zhang for their research assistance. All remaining errors and omissions are mine. Final revision accepted: October 2, 2015.

transfer and productivity spillovers, few have explored their effects on host country institutions. This is particularly surprising given that institutional development is argued to be a source of comparative advantage, affecting long-run development and growth (Acemoglu, Johnson, & Robinson, 2001, 2005; Kaufmann, Kraay, & Zoido-Lobatón, 1999; Knack & Keefer, 1995; Mauro, 1995), productivity and incomes (Hall & Jones, 1999) and trade and capital flows (Alfaro, Kalemli-Ozcan, & Volosovych, 2008; Dutt & Traca, 2010; Wei, 2000).

In this paper we contribute to this literature by addressing two questions. First, we explore whether bilateral FDI flows affect institutional development gaps (along multiple dimensions) between home and host countries. Second, we test if there is any difference between developed and developing country investors regarding their effects on institutional convergence dynamics in host countries. The empirical results based on bilateral FDI flows among 134 countries during 1990–2009 suggest that the institutional development effects of bilateral FDI flows from developed to developing countries as well as those from developing to developing countries are not significant and are not any different from each other. In either case we do not find any significant institutional convergence or divergence effect of FDI flows between host and home countries. We also do not detect any significant effect of aggregate North–South FDI flows on host country institutions. In contrast, we find that aggregate South–South flows have a significantly negative effect on host country institutions. Furthermore, we find some evidence that South–South FDI flows might be harmful to institutional development in natural resource-rich host countries while the opposite is true for South–North and North–South flows.

The organization of the paper is as follows: The next section provides a brief literature review on the link between FDI flows and institutional development. The third section introduces the methodology and data. The fourth section presents the empirical results followed by extensions in section five. The final section concludes.

2. LITERATURE REVIEW

There is a large and growing body of evidence suggesting that institutional development is important for long-run development and growth, and that developed (i.e., Northern) countries are endowed with better institutions than developing countries (i.e., Southern) (Acemoglu *et al.*, 2001; Alfaro *et al.*, 2008; Chong & Gradstein, 2007; Dutt & Traca, 2010; Hall & Jones, 1999; Kaufmann *et al.*, 1999; Knack & Keefer, 1995; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1999; Mauro, 1995; Wei, 2000). Nevertheless, there is no consensus in the literature either on the determinants of institutional heterogeneity across countries or on the causal relationship between institutions and long-run development (Khan, 2006).[2] Existing research identifies following variables as factors affecting institutional development: (a) natural resource base (Ades & Tella, 1999; Leite & Weidmann, 1999); (b) economic openness (Ades & Tella, 1999; Rigobon & Rodrik, 2005); (c) colonial past (Acemoglu *et al.*, 2001, 2005), slave trade (Nunn & Wantchekon, 2011), and pre-colonial governance structures (Gennaioli & Rainer, 2007); (d) initial wealth (Engerman & Sokoloff, 2002) and income inequality (Chong & Gradstein, 2007); (e) ethnic structures (Michalopoulos & Papaioannou, 2013) and ethnic fragmentation (Easterly & Levine, 1997); (f) past rulers (Caselli & Morelli, 2004); and (g) regional and international agreements and multilateral institutions (Busse, Königer, & Nunnenkamp, 2010; Thrasher & Gallagher, 2008; UNCTAD, 2011, 2014).

In global economic relations, developed countries together with developed-country-controlled bilateral and multilateral institutions (such as IMF and World Bank) are known to push for strong conditionality requirements in their economic exchanges with foreign governments involving trade policy, business environment, transparency, and rule of law (Lyman, 2005; Rodrik, 2008; Thrasher & Gallagher, 2008; UNDP, 2013). The legal barriers in developed countries also put pressure on foreign governments to synchronize their regulatory and institutional environments with those of their own. For example, the US Foreign Corrupt Practices Act (FCPA) of 1977 bans US firms from bribing foreign governments or businesses while no such law exists in China or India.[3] Furthermore, the US also launched the Kleptocracy Asset Recovery Initiative in 2010, which allows the Department of Justice to identify and repatriate stolen assets by corrupt foreign leaders and officials (US Department of Justice, 2012a; US Department of State, 2012). In the similar vein, the U.K. passed the Bribery Act in 2010 to fight corruption at home and abroad. Likewise, 40 countries around the world have ratified the OECD Anti-Bribery Convention of 1997 and yet 34 of those are OECD members.[4] These types of legislations can also have indirect effects by encouraging developing countries to adopt developed country standards and harmonize their institutional settings if they hope to engage in economic exchanges with the latter, including cross border investment flows (UNCTAD, 2012).

In contrast, developing countries are known to have lower conditionality requirements in their economic exchanges with other developing countries (Lyman, 2005; Gallagher, Irwin, & Koleski, 2012). Furthermore, despite the fact that a majority of prosecuted corrupt practices in Western jurisdictions involve developing countries, few, if any, prosecution takes place in those Southern jurisdictions themselves (Oduor *et al.*, 2014). Increasing rivalry between key emerging markets such as China and Brazil, and the West in having access to developing country economies, either for natural resources or market access might be one cause of this difference. The reported comparative advantage of developing country investors in their ability to operate in poor institutional environments may also be influential in this choice.[5] Furthermore, countries such as China often justify their lack of conditionality requirements by their refusal to impose their own set of values on sovereign host country governments, and by their willingness to "separate business from politics" (Lyman, 2005). Because of this lack of conditionality, growing South–South economic exchanges, particularly those involving financial flows, are often singled out as undermining Western country efforts to promote good governance and better institutions in developing countries with detrimental long-term development effects. (Economist, 2006; Graham-Harrison, 2009; Mbaye, 2011; Strange *et al.*, 2013; Warmerdam, 2012).

Another possible source of heterogeneity between Northern and Southern investors is argued to be the demonstration channel. Accordingly, the introduction of new methods of business practices through Northern multinational subsidiaries can trigger institutional change in the South (Kwok & Tadesse, 2006). On the other hand, the level of institutional and cultural similarity as well as closeness in technological and preference structures between countries can also affect the potential for institutional spillovers and convergence through economic exchanges (Amsden, 1987; Bahar, Hausmann, & Hidalgo, 2014; Bergstrand & Egger, 2013; Cheong, Kwak, & Tang, 2015; Regolo, 2013; UNIDO, 2005).[6]