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Exploring the relationship between institutional factors and FDI attractiveness: A meta-analytic review

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A B S T R A C T

This meta-analysis attempts to synthesize and review decades of research on the relationship between institutional factors and host country foreign direct investment (FDI) attractiveness. Using prior tests derived from 97 primary studies, we find support for prior theoretical predictions that institutional factors such as political stability, democracy, and rule of law attract FDI, while others such as corruption, tax rates and cultural distance deter it. Further evidence suggests a need for exploration of moderating factors that may influence previous key findings. Specifically, environmental effects such as level of development, region of destination, and competitive industry environment have varying influence on the strength and significance of the relationship. We also explore a number of methodological and economic moderating variables, providing additional interesting insights into previous empirical analyses. We conclude with suggestions for future research that stress a call for further contextualization of the relationship.

1. Introduction

For decades scholars have been interested in exploring the main factors that determine a country's level of FDI attractiveness. Traditionally, scholars focused on economic factors such as market size, labor costs, exchange rates, infrastructure, and others as the key explanatory factors in determining a host country's ability to attract or deter FDI (Caves, 1974; Dunning, 1980; Grosse & Trevino, 1996). In the 1990s, following the highly influential work of North (1990), FDI researchers began to focus more attention on the influence of institutions (Gastanaga, Nugent, & Pahamova, 1998; Globerman & Shapiro, 2002, 2003; Loree & Guisinger, 1995), defined as the "rules of the game in a society or…the humanly devised constraints that shape human interaction" (North, 1990: 3).

The relationship between institutional factors and FDI attractiveness is commonly described through its positive or negative effects, with factors such as democratic institutions, political stability, and rule of law attracting FDI (e.g. Globerman & Shapiro, 2003; Loree & Guisinger, 1995; Sethi, Guisinger, Phelan, & Berg, 2003) and factors such as corruption, tax policies and cultural distance (e.g. Globerman & Shapiro, 2003; Habib & Zurawicki, 2002; Loree & Guisinger, 1995) deterring FDI. While these studies have contributed greatly to our understanding of the influence of institutional factors on FDI attractiveness, they often lack consistency in their findings. For example, some scholars find that political stability is positive and significantly related to FDI (Loree & Guisinger, 1995; Sethi et al., 2003), while others find no significant relationship between the variables (Globerman & Shapiro, 2003; Kobrin, 1976). The relationship between tax rates and FDI is also inconsistent: several scholars find a negative and significant relationship between tax rates and FDI (e.g. Gastanaga et al., 1998; Loree & Guisinger, 1995), while others find no significant relationship (Chakrabarti, 2001; Swenson, 1994; Wheeler & Mody, 1992).

Some factors may also need further exploration. For example, Cuervo-Cazurra (2006) finds that while FDI from low corruption home-countries is deterred by high host country corruption, FDI from high home to host country corruption may actually prefer to invest in these environments. Similarly, the negative relationship between cultural distance and FDI may depend on economic and other contextual factors (Bailey & Li, 2015; Grosse & Trevino, 1996; Loree & Gusinger, 1995). We find through a review of the FDI attractiveness literature that the exploration of contextual moderation remains significantly underdeveloped.

Given the inconsistencies in previous findings and the lack of research on moderating factors, it is of critical importance to take stock of the current state of the literature (Kirca & Yaprak, 2010) on the institutional factors and FDI attractiveness relationship. Specifically, the contributions of this article are threefold. First, we synthesize the previous findings both qualitatively and through a meta-analytic replication study, which to our knowledge is the first of its kind. Meta-analysis has become increasingly common methodology due to its ability to convert statistical results across unique studies into one common metric, which provides more accurate assessment of the nature of the

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relationship than any single empirical study (Liu, Vredenburg, & Steel, 2014) and a more comprehensive analysis than is possible under traditional qualitative reviews (Stahl, Maznevski, Voigt, & Jonsen, 2010). Second, we push past simply synthesizing the previous literature to hypothesize that several environmental effects, namely (1) level of development, (2) region of destination, and (3) competitive environment, may help explain the significant variation in previous results on the focal relationship. Third, we further investigate the moderating effects of several methodological factors through meta-analytic regression analysis, which leads to new and interesting insights and allows us to better understand which factors, when included in the analysis, strengthen or weaken the relationship.

We begin with a systematic review of the theoretical mechanisms, variables and methodologies used in prior studies on the influence of institutional factors on FDI attractiveness. Second, we present the methodology in our meta-analysis and our findings, then conclude with a discussion on future directions for the relationship.

2. Literature review

Foreign direct investment (FDI) is an "investment made to acquire a lasting interest in or effective control over an enterprise operating outside of the economy of the investor" (UN, 2007). This definition implies that a long-term relationship, one that is not undertaken without significant consideration by multinational enterprises (MNEs). Previous scholarship focuses on what factors entice MNEs to choose to invest in one host country over another. Economic factors were the primary focus initially, with institutions playing a more prominent role in the discussion more recently.

Through our review of the previous literature, the theoretical base for explaining the relationship between institutions and FDI comes largely from an economics perspective, namely the costs associated with choosing one host country over another. Regarding the influence of institutions, government policies and other institutional factors can increase or decrease costs, and ultimately influence profitability (Root & Ahmed, 1978). Host countries with market-based institutional factors, which constrain opportunistic behavior (Fan, Morck, Xu, & Yeung, 2009), encourage foreign competition, and allow MNEs to exploit ownership advantages abroad, are likely to decrease costs and attract FDI (Grosse & Trevino, 1996; Li & Resnick, 2003). Market supporting institutions are similarly beneficial because they allow efficiency-seeking investors to realize cost-saving benefits of internalizing production (Meyer & Nguyen, 2005) and protect intellectual property from being appropriated (Khoury & Peng, 2011). Several scholars have suggested that overall MNEs prefer a liberal general environment for FDI (Globerman & Shapiro, 2003; Sethi, Guisinger, Ford, & Phelan, 2002, 2003). Conversely, institutional factors that increase costs create inefficiencies in markets and allocation of resources, and are therefore likely to deter FDI (Cuervo-Cazurra, 2006; Grosse & Trevino, 1996; Habib & Zurawicki, 2002; Robertson & Watson, 2004). Unreliable institutional environments can also create uncertainty, rendering a particular environment less predictable and hence a deterrent for FDI (Buthe & Milner, 2008; Globerman & Shapiro, 2003; Jensen, 2003; Woodward & Rolfe, 1993).

Thus, those host governments most successful in attracting FDI will provide at a minimum a stable political environment where market-based institutions are reliable and predictable and public institutions that allow MNEs to exploit their home-country advantages, increase efficiency and thereby reduce costs (Sethi et al., 2002, 2003). In short, "good government" attracts FDI (Fan et al., 2009).

Based on our review, the following six institutional factors receive the most significant scholarly attention in increasing or decreasing the costs associated with cross-border economic activity, and result in either attracting or deterring FDI: (1) political stability, (2)rule of law, (3) democratic institutions, (4) corruption, (5) tax rates, and (6) cultural distance. While there are certainly others, these factors are the most frequently cited, clearly conceptualized, and empirically tested in the FDI attractiveness literature.[1] The first four of the six institutional factors align closely with the world governance indicators from the World Bank (Kaufmann, Kraay, & Mastruzzi, 2009). The fifth, tax rates, is a government fiscal policy often manipulated by host governments to attract FDI. The final factor, cultural distance, is not government related, but considered an informal institution that reflects cultural differences between home and host countries. Although it is somewhat dissimilar from the other five, we include it here for several reasons: 1) it is cited in a substantial number of articles as deterring FDI when the distance between home and host country is high, 2) it is often viewed as an informal institution that affects the "rules of the game" within a host country; and (3) can carry significant cost to MNEs if not accounted during location decision-making.

For each institutional factor, we discuss the theoretical arguments, empirical findings and how the variables are operationalized. Our analysis uncovers very few criticisms by scholars of alternative operationalizations and sources of institutional variables to those used in their respective papers. We highlight a few of those sources and operationalizations below under each applicable institutional factor.

2.1. Political stability

Political stability is broadly defined as the likelihood that the government will be destabilized or overthrown (Kaufmann et al., 2009). MNEs favor political institutions that are stable, credible and honest (Globerman & Shapiro, 2003), because they increase legitimacy within the host country (Trevino, Thomas, & Cullen, 2008). Political instability makes a country less attractive because it creates an unpredictable environment (Buthe & Milner, 2008; Loree & Guisinger, 1995; Woodward & Rolfe, 1993) that may disrupt economic processes (Schneider & Frey, 1985). The unpredictability of instable political environments increases the costs of internalizing production (Jensen, 2003), and ultimately negatively affects profitability.

While the theoretical underpinnings suggest that political stability should be positively related to FDI, the results are mixed when empirically analyzing the relationship. Some certainly find political stability to be positively and significantly related to FDI (Campos & Nugent, 2003; Loree & Guisinger, 1995; Sethi et al., 2003; Woodward & Rolfe, 1993). However, others find political stability does not influence FDI flows (Globerman & Shapiro, 2003; Kobrin, 1976), which holds across a number of contexts, such as in less developed countries (Kobrin, 1976), in Latin America (Trevino et al., 2008) and within technology intensive industries (Globerman & Shapiro, 2003). Since the results do not reach consensus, political stability may or may not influence FDI flows.

There are several sources for the political stability variable. Loree and Guisinger (1995) and Woodward and Rolfe (1993) use a composite index variable that measures political risk from the ICRG; Campos and Nugent (2003) and Kobrin (1976) draw data from Barro and Lee (1993), an updated version of the Banks (1971) dataset, which measures the number of assassinations and revolutions per year; Sethi et al. (2003) a 100 point scale from the Association for Investment Management and Research where a higher score indicates greater stability; Trevino et al. (2008) the Policy Constraints Index, which measures the likelihood of a major host country political or policy change; Globerman and Shapiro (2003) an index of armed conflict, social unrest, ethnic tension, terrorist threats, etc. from the World Governance Indicators (WGI).

In this case, there is no consistency in variable choice across disciplines. Where there is overlap, both Loree and Guisinger (1995) and Woodward and Rolfe (1993) find similar results, while in Campos and

[1] Similar factor lists are found in well-cited articles such as Globerman and Shapiro (2003) and Pajunen (2008).

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