

# **FOREIGN DIRECT INVESTMENT AND SOCIAL POLICY: THE LINKS IN DEVELOPING COUNTRIES**

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*This paper applies institutional economics and public-choice theories to a unique dataset of 59 developing countries to examine the association between foreign direct investment flows and host governments' social inclusion or pro-social policies. The findings suggest that there is a link between the two. Further testing reveals that two pro-social policies have a positive effect on a country's ability to attract foreign direct investment: the equity of public resource use and social protection policies. The results highlight social inclusion government policy as a two-pronged good, benefiting the social welfare of its citizens as well as attracting FDI.*

Globalization, the “ongoing process of integration and interconnection of states, markets, technologies, and firms” (Barkema, Baum, & Mannix, 2002), is an economic reality of the 21<sup>st</sup> century whose benefits have been called into question by many (e.g., Stiglitz, 2003; Wessel & Davis, 2007). While private investment flows rise commensurately with globalization, policymakers continue to debate whether the integration of markets is contributing to or detracting from such important objectives as social inclusion, environmental protection and poverty reduction. This paper enters the debate using new institutional economics and public-choice theories to explore the relationships among actors in private business and foreign governments. It is also a response to the recent call for a more inclusive view of institutions, one that

takes into account their socio-economic outcomes (Casson, della Giusta, & Kambhampati, 2009). While the determinants of foreign direct investment (FDI) have already received ample attention in economics and international business research (Asiedu, 2002; Contractor, 1991; Loree & Guisinger, 1995; Schneider & Frey, 1985), we examine the direct impact that host governments have on attracting FDI in their role as promoters of social welfare and inclusion. Is pro-social government policy a two-pronged social good: for the citizens it benefits and for the investment it brings into the country?

There has been a dearth of empirical studies that examine the *social* ground rules in place in a host country's institutional environment. This paper contributes toward a deeper understanding of the link between the institutional environment of a host country and its ability to attract foreign direct investment by testing the relationship between the host country's social fabric and its levels of FDI. This study examines the extent to which foreign direct investment and desirable social outcomes operate in tandem. It attempts to make the axiom, "act locally, think globally" more relevant, broadening its scope to include the social element of the institutional environment, the context in which organizations operate outside of their borders.

This paper takes the following format. First, it develops theoretical rationales and proposes two hypotheses. It then presents and describes the data, explains the methodology used to test the hypothesis empirically, and provides the results. Next it discusses the main findings, the limitations of the study, and possible avenues for future research. It closes with concluding remarks.

## THEORY AND HYPOTHESES

Host governments have always been concerned about how to strategically position themselves in an increasingly competitive market for a limited supply of investment resources. Competition is fierce, as many countries offer similar attractions to investing firms, *e.g.*, tax breaks, profit repatriation, low domestic content requirements, etc. (Dunning, 1998; Moran, 2002). At the firm level, recent empirical research has corroborated the association between “good” companies and higher profit levels and, conversely, “bad” companies and decreasing bottom lines (Harris & Bromiley, 2007). Just as socially responsible firms have redefined the concept of value creation, broadened their stakeholder base, and taken advantage of positive reputational effects in their quest for profits, might not countries similarly create value for one constituency while simultaneously hoping to reap benefits from another?<sup>1</sup> We ask whether the same relationship applies at the country level: that is, are “good” countries rewarded with more foreign direct investment (FDI). Is there an association between pro-social public policy and the capture of global private investment? We are particularly interested in those economies in earlier stages of development, where pro-social policies are a rarer phenomenon, and restate our main research question thus: What is the relationship between the ability of a developing economy (host country) to attract private investment and the quality of socially-oriented policies it has in place that beneficially affect the lives of its citizens?

We attempt to answer this research question by applying two competing theories: new institutional economics and public

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<sup>1</sup> Archipugi & Pianta (1992) make the link between firms and countries, stating that what is true for one group can also be applied to the other.

choice. In new institutional theory, the institutional environment is defined as those fundamental political, social, and legal ground rules that establish the basis for production, exchange, and distribution (Davis & North, 1971), outlining the conditions under which business occurs (North, 1990). The overarching assumption is that institutions matter (North, 1990; Williamson, 2000). Institutions are defined as the “rules of the game” and they include formal and informal norms. The former group refers to the formal written laws and contracts that represent the choices made by a society to give structure to its relations with others. The latter group consists of the internally enforced modes of conduct that modify behavior and form the subjective perceptions of members of a society, *i.e.*, norms of behavior, culture, values, attitudes, and conventions. While we are aware of the power of informal institutional constraints and understand that values and belief systems underpin the laws of a society (North, 1990, 2005), in this paper we focus on the interplay of formal institutions (implemented government policies) to explore the association between a host country’s ability to attract FDI and the formal rules and regulations that it has in place that affect the *social* well-being of its citizens.

Countries with weak institutions pose challenging problems for direct investment by firms. The notion of “institutional voids” has been used to describe those countries, especially in the developing world, that lack the basic regulatory and judicial institutions that allow economic activity to flourish (Khanna & Palepu, 1997). Specifically, these voids can range from a weak political structure and a closed labor market to a controlled media and underdeveloped social systems that encumber arms-length transactions (Khanna, Palepu, & Sinha, 2005). The upshot is that even if a firm is willing to adapt its business model to comply with a country’s institutional context, weak institutions represent costs

in product markets, input markets or both. It follows that private investment will think twice before entering a market where the institutional voids are overwhelming. Other theoretic evidence highlights the importance of the social dimension in assessing institutional configurations across countries. In this perspective, social norms are “embedded” within contexts across different settings, such as regions and countries, and enable social networks as well as state intervention to serve as coordination mechanisms to help markets operate smoothly (Granovetter, 1985). Similarly, North, Wallis, & Weingast (2009) contrast open-access and limited access societies and theorize that an association exists between the institutional constraints that govern a population and their effect on societal outcomes, in this case a society’s penchant for violence.

Other academic research has examined the role that non-market, institutional factors play in multinational firms’ investing decisions (Boddewyn & Brewer, 1994; Dunning, 1998). Among the topics that have received empirical and theoretical attention are how the polity and political risk level in a host country affect cross-border investment (Click, 2005; Henisz, 2000; Hill, 1998; Kobrin, 1979, 1982; Moran, 2004); how government constraints hinder multinational firms’ competitiveness vis-à-vis domestic firms (Yu & Cannella, 2007); how the legal environment and the property rights regimes in host countries influence multinational firms’ cost of doing business abroad (Delios & Beamish, 1999; Hennart, 1982; Oxley, 1999; Shan, 1991), and how institutions, physical infrastructure, and financial development can negatively affect FDI into developing countries (Kinda, 2009). Marcus, Islam, & Moloney (2008) examine the role of demographics across countries and conclude that when vast “bulges” exist in age and in economic power, or if society does not provide ample employment for a large segment of a particular socio-economic group, violence can result. While hostile behavior is not the focus of the present

study, the social science research on violence indicates that a country's social institutions do inform the overarching institutional context.

The aforementioned studies indicate that the economic, legal and political dimensions of the institutional environment have received more empirical scrutiny in explaining country- and firm-level phenomena than has the social dimension. Standard risk evaluations by professional rating services have also typically overlooked the social hazards that can impact a country's competitiveness. To wit, although the highly regarded risk assessment of the International Country Risk Guide (ICRG) includes one variable on socio-economic conditions prevalent in a country, it does not gauge the strength of social institutions and their role in determining the attractiveness of a country for foreign direct investment. Like other risk instruments, the ICRG rating system focuses on economic, political, and financial conditions in its modeling of countries' investment environments.

New institutional theory purports that institutional environments that provide strong political, social, and legal institutions reduce transactions costs, protect property rights, and lessen the uncertainty of doing business on foreign soil. Consequently, inclusive social programs, an integral component of a society's institutional context, are likely to contribute to a positive perception of a country. All else equal, a society that provides for the social welfare of its citizens, from equal access for men and women and access to education, to protection of their health and laws against discrimination and environmental degradation, will be perceived as possessing a robust institutional foundation. Based on the preceding theoretical logic, we posit the following hypothesis:

**Hypothesis 1:** *Ceteris paribus*, the presence of pro-social policies in a country will be positively associated with its ability to attract foreign direct investment.

In contrast, the logic underpinning public-choice theory points out the tendency of many governments to act in opportunistic and self-seeking ways, resulting in less desirable social and economic outcomes. Contrary to received theory about the role of government to improve the lives of its citizens, to provide a safety net for their well-being, and to “put right any perceived injustices of the market place” (Dunning, 2003:18), public-choice theory posits that governments are made up of individuals who often behave in ways that enhance their personal gain at the expense of the public good (Tullock, 1967; Stigler, 1971). Likened to the collections made at a tollbooth, this theory asserts that governments can regulate industries and entry into them (and by extension, foreign direct investment) by collecting and pocketing fees for their own use. In an empirical study on the effects of government regulation of entry on new business, for example, Djankov, La Porta, Lopez-de-Silanes & Shleifer (2002) suggest that despotic regimes are more likely to limit access to their countries’ markets to a small group of cronies rather than to let them operate freely, thus perpetuating a system that rewards the “ins” and punishes the “outs.” The collection of bribes is often the price for letting foreign investors or even domestic businesses gain entry into an industry. As the World Bank notes:

When someone has finally made the decision to invest, he then is subjected to some of the worst treatment imaginable . . . in a few cases this treatment consists of outright extortion: presenting the investor with insurmountable delays or repeated obstacles unless he makes a large payoff . . . .

(World Bank, 1999:10).

The public-choice perspective, then, views governments as opportunistic actors who are unlikely to be concerned with the social welfare of their citizens. They design and implement the rules of the game – both legal and extra-legal – to maintain a system that rewards self-seeking behavior for those in power. Public-choice theory would therefore predict that pro-social policies are not on the agenda for governments that prize their personal gain over the greater public good and, consequently, social policies will not influence inward FDI flows. Hence:

**Hypothesis 2:** *Ceteris paribus*, the presence of pro-social policies in a country will have no effect on its ability to attract foreign direct investment.

## METHODS

### *Sample*

To draw a sample of developing countries for the empirical context of our study, we used the World Bank's Country Policy and Institutional Assessment (CPIA 2005) dataset. Since 1977, these data annually evaluate 136 countries on the quality of their policy performance in four basic areas: Economic Management, Structural Policies, Policies for Social Inclusion/Equity, and Public Sector Management and Institutions. Three of these areas are not new to empirical analysis, since numerous rankings have been developed to assess the quality of institutions and performance in economic management, structural policies and public sector management (Kauffman, Kraay, & Mastruzzi, 2009). What is valuable to researchers about the CPIA is the social inclusion category. First made available to the public in 2006, the CPIA provides numeric scores for five disaggregated groups that reflect the quality of pro-social policies. A total of 77 countries were ranked in 2005 for their social inclusion policies; these constitute

the empirical context for this study. Seventeen countries had to be excluded for lack of homogeneous GDP, FDI or other information, thus yielding 59 countries with adequate data on which to base our analysis. [Appendix A](#) provides a list of the countries included in the final sample.

### *Measures*

Dependent variable.

FDI flows to emerging market economies have increased dramatically over the past 15 years, despite the financial market setbacks in many countries ([Brukoff Rother, 2007](#)). In fact, multinational firms provide the largest proportion of worldwide FDI monies and are the single largest source of emerging markets' net capital inflows ([International Monetary Fund, 2003](#)). As a proxy for private investment by multinational corporations worldwide, we use the natural log of foreign direct investment inflows as our dependent variable, averaged for the 2000-2005 period. (This eliminates countries with negative net inflows from our sample.) FDI net inflows serve as a reflection of the confidence that foreign investors have in the local economy and their expectations of growth, economic success and company profits on an aggregate level. We follow the IMF's definition of FDI: international investment that reflects the objective of a resident in one economy (the direct investor) to obtain a lasting interest in an enterprise resident in another economy (the direct investment enterprise). A direct investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad ([International Monetary Fund, 2005](#)).

#### Independent variables.

The construct of host government social policies is operationalized using the World Bank's Country Policy and Institutional Assessment (CPIA) score for the quality of pro-social policies used by host governments in the sample of 59 developing countries. The CPIA social policy measure is a numerical index that encompasses five distinct dimensions. Together it assesses the extent to which a country's policies for social inclusion and equity support sustainable growth and poverty reduction. The score ranges from a minimum of 1 to a maximum of 6. A relatively high CPIA social policy score indicates the presence of more socially inclusive legislation; a relatively lower score means that less pro-social legislation is in place. The average score for our sampled countries in 2005 was 3.27.

The five dimensions that define a country's social inclusion/equity policies and that constitute the aggregate CPIA index used in this study are: gender equality, building human resources, equity of public resource use, social protection and labor, and policies and institutions for environmental sustainability. [Appendix B](#) provides a complete description of what each of these criteria includes.

#### Control variables.

Several alternative explanations for an increase in a recipient country's level of inward FDI flows are possible. The attractiveness of a host country for investing firms depends, in large part, on the size of its market ([Contractor, 1991](#); [Delios & Henisz, 2003](#); [Dhanaraj & Beamish, 2004](#); [Loree & Guisinger, 1995](#)). We therefore control for the size and attractiveness of the host country's macro economy as an alternative explanation for multinational firms' choices to channel FDI there. To that end, we include as control variables three country-level macroeconomic

indicators to represent different facets of size: host country economic growth rate and host country population.

- GDP growth, the annual % change of output in real terms, reflects the strength of the local economy and the increase in the size of the domestic market, opening the door to larger sales and higher profits. Thus higher GDP growth should generally be associated with larger FDI inflows.
- Population is another indicator of market size. All other factors remaining equal, FDI is most likely to be attracted to economies with both large populations and higher GDP per capita. Following previous researchers, we use the natural log of the host country's population.
- Inflation enters the regression as a proxy for macroeconomic stability and as a reflection of the internal or external shocks suffered by the economy during the period under study, which may affect potential direct investors. A high and/or variable rate of inflation is a sign of internal economic instability and of the host government's inability to maintain consistent monetary policy. It also may boost costs, making exports from the region less competitive on international markets (Grosse & Treviño, 2005).

Two other control variables were included to reflect possible alternative factors in a host economy that might influence a foreign investor's decision.

- If a host country produces oil, it may favorably skew its chances of receiving large FDI projects. We controlled for this possibility by using a dummy variable for oil producing countries (1=oil-producing; 0=otherwise).
- The trade openness of the host country, that is, its (exports + imports)/GDP, is controlled for, because an economy that is more deeply integrated into the world trade system is a

more attractive environment for foreign investment (Grosse, 1997; Grosse & Treviño, 1996). It is also more likely not only to receive FDI inflows but also to experience higher rates of GDP growth and per-capita GDP growth, all else equal (Maddison, 2001).

For the control variables, except oil, a simple average of the values for the 2000-2005 period was used, in order to represent the period immediately prior to and coinciding with the CPIA social policy score. An overview of all variables, their measurements, definitions, and sources is reported in [Table 1](#).

#### *Modeling and analysis*

The relationships among these variables were assumed to be linear and an ordinary least-squares regression was used. The model specification takes the following forms:

$$\text{Model 1: } \text{LnFDI}_i = \beta_0 + \beta_{i1-5} \text{CONTROLS} + \varepsilon$$

$$\text{Model 2: } \text{LnFDI}_i = \beta_0 + \beta_{i1-5} \text{CONTROLS} + \beta_{i6} \text{SOCIALPOLICY} + \varepsilon$$

where  $\text{LnFDI}_i$  is the dependent variable (the natural log of FDI inflows in country<sub>*i*</sub>);  $\beta_{i1-5}$  represents the set of five control variables described above;  $\beta_6$  represents the overall CPIA score for social inclusion policies – which includes each of the five subsets of that score in country<sub>*i*</sub>; and  $\varepsilon$  is the error term for the regression. Regional dummies were also used to control for region-specific effects on FDI flows.

**TABLE 1**  
**Data Labels, Measurements, Definitions and Sources**

Label	Variable	Measurement	Definition	Source
FDI inflows	Dependent	Natural log of FDI net inflows, averaged over two years (2000 and 2005)	Net foreign direct investment inflows or the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.	<i>World Development Indicators 2000-2005 (The World Bank)</i>
GDP growth	Control	5-year average (2000-2005) annual real GDP percentage growth rate	How fast output/income is growing in host country.	<i>World Development Indicators 2000-2005 (The World Bank)</i>
Population	Control	The natural log of 5-year average (2000-2005) of host country population	How large the host country is in terms of its population.	<i>World Development Indicators 2000-2005 (The World Bank)</i>
Inflation	Control	Change in annual consumer price level, average 2000-2005	Average annual increase in price level; reflection of internal and external shocks.	<i>World Development Indicators 2000-2005 (The World Bank)</i>
Oil	Control	Dummy variable: 1 = oil-producing country; 0 = otherwise	Whether the host country is an oil-producing nation.	<i>The Energy Information Agency website (<a href="http://eia.doe.gov/">http://eia.doe.gov/</a>)</i>

Label	Variable	Measurement	Definition	Source
Trade openness	Control	(Imports plus exports)/GDP, average 2000-2005	The weight of trade (imports plus exports) in the national economy.	<i>Penn World Tables 2000-2005</i>
Social policy	Independent	Score 1-6, with higher numbers reflecting more pro-social policies	The extent to which a host government has policies in place that promote social inclusion. The overall score is based on five dimensions of social inclusion: gender equality, equity of public resource use, building human resources, social protection and labor, and policies and institutions for environmental sustainability.	<i>Country Policy and Institutional Assessments Questionnaire, World Bank 2005</i>

## RESULTS

This study explored the association between pro-social policies and private investment in the form of FDI flows. The correlation and descriptive statistics matrix is provided in [Table 2](#); the results are reported in [Table 3](#).

Multicollinearity is not a problem in this dataset. The maximum variance inflation factor (VIF) obtained for our models was 3.022 and the overall mean VIF was 1.5, well within the acceptable limits for multiple regression models. Three control variables did not achieve statistical significance. A positive and

**TABLE 2**  
**Correlation Table and Descriptive Statistics**

Variable	Mean	Std. Deviation	1	2	3	4	5	6
1 FDI inflows	18.0992	2.0413	1					
2 GDP growth	4.2157	3.1919	.447(**)	1				
3 Population (log)	15.6974	2.0047	.597(**)	.261(*)	1			
4 Inflation	14.7625	48.1228	.025	-.369(**)	.096	1		
5 Oil	.29	.457	.603(**)	.241	.501(**)	-.019	1	
6 Trade openness	76.1712	40.9777	-.045	-.084	-.555(**)	-.180	-.157	1
7 Social inclusion policies	3.2763	.5066	.324(*)	.311(*)	.065	-.343(**)	-.022	-.094

\*p < .05; \*\*p < .01

**TABLE 3**  
**Results of OLS Regression**

<i>Dependent Variable:</i> Natural log FDI inflows	Model 1 (baseline model)	Model 2
<i>Control Variables</i>		
% GDP growth	0.049 (0.000)	0.015 (0.000)
Population (log)	-0.124 (0.124)	-0.187 (0.122)
Inflation rate	-0.030 (0.003)	0.056 (0.003)
Oil producer	0.360*** (0.373)	0.425*** (0.375)
Open economy	0.526*** (0.004)	0.517*** (0.004)
<i>Independent Variable</i>		
Social inclusion policies		0.252* (0.340)
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Regional dummies	Yes	Yes
N	59	59
Constant	0.782	-0.662
Adjusted R <sup>2</sup>	0.643	0.701

Standard errors are in parentheses below each coefficient.

<sup>+</sup> p < 0.10, \* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.001

statistically significant relationship was found between FDI inflows and a host country's producing oil as well as between FDI inflows and a host country's fostering an open economy. Our key variable of interest, host government social policies, was correctly signed and statistically significant. The association that we predicted between pro-social government policies and private foreign direct investment was thus confirmed; [Hypothesis 1](#) found support. [Hypothesis 2](#) was consequently not corroborated. Therefore, the relationship as predicted by the new institutional economics theory is upheld, that is, that the presence of pro-social policies has a positive effect on FDI flows. Between the two competing theories, it would appear that institutional theory holds more sway than public-choice theory in attracting FDI.

To check the robustness of our results, we included a dummy variable for region, to see whether certain geographic regions had any effect on the behavior of our variable of interest. While Africa and Latin America and the Caribbean had positive and statistically significant influences on the level of FDI flows, the coefficients from other regions in the world were not statistically different from zero. The regional dummy results are not reported.

Theory did not permit us to argue for and hypothesize individual social policies. Nevertheless, since we found a correctly signed and statistically significant effect of the overall index of a government's social inclusion policies on inward FDI flows, we ran further statistical analyses to ascertain which of the five social policy dimensions in the CPIA contributed to this outcome. The correlation table and descriptive statistics for each social inclusion policy sub-group are described in [Table 4](#). [Table 5](#) reports the regression results.

TABLE 4  
Correlation Table and Descriptive Statistics  
of Social Inclusion Policy Sub-Groups

Variable	Mean	St. Dev.	1	2	3	4	5	6	7	8	9	10	
1 FDI inflows	18.0993	2.0414	1										
2 GDP growth	4.2158	3.1919	.447(**)	1									
3 Population (log)	15.6974	2.0048	.597(**)	.261(*)	1								
4 Inflation	14.7625	48.1229	0.025	.369(**)	0.096	1							
5 Oil	0.2881	0.4568	.603(**)	0.241	.501(**)	-0.019	1						
6 Trade openness	76.1712	40.9778	-0.045	-0.084	.555(**)	-0.18	0.157	1					
7 Gender equality	3.4237	0.6683	0.204	0.173	-0.148	-0.196	0.096	.345(**)	1				
8 Equity of public resource use	3.4068	0.6330	.319(*)	.404(**)	0.181	.404(**)	0.065	-0.029	.513(**)	1			
9 Building human resources	3.4068	0.5907	0.247	0.219	0.056	-.325(*)	0.005	0.057	.691(**)	.714(**)	1		
10 Social protection & labor	3.1017	0.5631	.298(*)	.400(**)	0.075	.370(**)	0.018	0.009	.662(**)	.753(**)	.755(**)	1	
11 Policies & institutions for Environmental sustainability	3.0424	0.5276	.319(*)	0.117	0.138	-0.157	0.087	-0.024	.559(**)	.619(**)	.691(**)	.566(**)	1

\*p < .05; \*\* p < .01

**TABLE 5**  
**Results of OLS Regression**  
**with Social Inclusion Policy Sub-Groups**

Dependent Variable:	Model 1 (baseline model)	Model 3	Model 4	Model 5	Model 6	Model 7
Natural log FDI inflows						
Control Variables						
% GDP growth	0.049 (0.000)	0.024 (0.000)	0.029 (0.000)	0.032 (0.000)	0.029 (0.000)	0.017 (0.000)
Population (log)	-0.124 (0.124)	-0.129 (0.122)	-0.204 (0.125)	-0.150 (0.124)	-0.161 (0.119)	-0.198 (0.127)
Inflation rate	-0.030 (0.003)	-0.002 (0.003)	0.069 (0.003)	0.017 (0.003)	0.080 (0.003)	0.000 (0.003)
Oil producer	0.360*** (0.373)	0.403*** (0.379)	0.406*** (0.373)	0.385*** (0.376)	0.423*** (0.367)	0.413*** (0.384)
Open economy	0.526*** (0.004)	0.486*** (0.004)	0.539*** (0.004)	0.533*** (0.004)	0.529*** (0.004)	0.516*** (0.004)

Dependent Variable: Natural log FDI inflows	Model 1 (baseline model)	Model 3	Model 4	Model 5	Model 6	Model 7
<b>Independent Variables</b>						
Gender equality	0.205 (0.282)					
Equity of public resource use		0.228+ (0.275)				
Building human resources			0.147 (0.267)			
Social protection & labor				0.304** (0.305)		
Policies & institutions for environment sustainability					0.175 (0.313)	
<b>Regional dummies</b>						
N	Yes 59	Yes 59	Yes 59	Yes 59	Yes 59	Yes 59
Constant	0.782	-0.415	-0.017	-0.029	-0.963	0.212
Adjusted R <sup>2</sup>	0.609	0.639	0.634	0.641	0.648	0.691

Standard errors are in parentheses below each coefficient. † p < 0.10, \* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.001

Although highly related to one another, as expected, the social inclusion policies are not unduly correlated. The highest correlations are between social protection and labor policies with two other policy sub-groups: the equity of public resource use and building human resources. Their correlations are .753 and .755, respectively. The variance inflation factors for all variables in this subset ranged from 1.456 to 3.696, well below a VIF score of 10 (Hair, Anderson, Tatham, & Black, 1998). The sub-category of social inclusion policy called “equity of public resource use” achieved mild statistical significance when it entered the model (Model 3), while the “social protection and labor” dimension attained statistical significance at the <1% level in Model 6. Both were positively signed. The other sub-groups were not statistically significant.

## DISCUSSION

Scholars have previously discussed the idea that countries that establish pro-social domestic policies provide a more attractive institutional framework for investment for reasons other than market size (Blanton & Blanton, 2006; Kucera, 2002; Norman & MacDonald, 2004). Their reasoning includes the normative and image-related risks of operating in countries with repressive regimes; the risk and uncertainty spawned by repressive policies in the host economy; and the growing importance of a “triple bottom line” for firms that want to establish a good reputation in corporate social responsibility. Though these authors did not use a comprehensive data set like the CPIA to quantify the pro-social nature of a host country’s policies, they used several proxies for non-repressive, clean or pro-social government to demonstrate this association.

This study's findings are consistent with the notion that a strong institutional environment will decrease uncertainty, increase efficiency, and send the right signals to the market place. Specifically, it yields one striking and significant policy implication: foreign investors do pay attention to some of the social policies a host government has in place in some of the world's least developed countries. The evidence suggests that developing countries with certain pro-social policies that enhance the social welfare of their citizens are more likely to attract FDI flows. This finding is inconsistent with the contention that FDI flows have set the world's poor countries on a race to the bottom, *i.e.*, creating a pro-business environment at whatever social and environmental cost.

Additionally, the results of this study indicate that governments with pro-social policies that explicitly promote the equitable use of public resources to combat poverty and that provide social safety nets and minimal welfare protection to benefit their citizens attract more private FDI monies, *ceteris paribus*. Since only these two of the five policy sub-groups in the model were statistically significant (the equity of public resource use and social protection & labor), this begs the question: if institutions matter (as our findings confirm), why do some aspects of the institutional environment matter more? Why do these particular pro-social policies influence FDI inflows and not the others? Broadly speaking, this result suggests that not all social policies are equal; some carry more weight in the international arena and are perceived differently by private investors. While this result is consistent with our overarching logic that institutions make a difference in the levels of inward FDI, one could equally argue that foreign investors might be less likely to invest in countries with these particular policies in place because they would tend to raise labor costs through taxes or other mandatory

contributions. It is beyond the boundary conditions of this paper to justify why the equity of public-resource use and social protection and labor programs appear to be more important for FDI than others, however, since the hypotheses made predictions about social policies in general. More empirical scrutiny is required to shed light on this interesting ancillary finding.

With regard to implications for policy makers and management executives, we are necessarily circumspect in our advice. The results of this study, while providing evidence for the importance of the social element of the institutional environment, yielded mixed results when testing the individual pro-social indicators. Moreover, theory does not distinguish among the various social indicators, thus precluding specific policy or strategic recommendations. We simply state that the results of this study imply that pro-social government policies, as part of a country's institutional environment, do influence levels of foreign direct investment. Host governments and multinational firms need to factor into their decision-making equations how social programs will affect their respective objectives of attracting and conducting foreign direct investment.

#### *Limitations*

This study has limitations. First, it examines a sample of the world's poorest countries. Future researchers may wish to expand the dataset to include low and medium-income countries to examine how the variance in social policies across countries of differing wealth affects private investment. Second, the unit of analysis of this study was at the country level. Since most FDI is driven by large cross-border mergers and acquisitions ([International Monetary Fund, 2003](#)) and since the policy outcomes that this paper highlights address both policymakers and managers, more analyses at the firm level are needed to better

understand the behavior of multinational corporations and their host country affiliates. Third, we used a cross-sectional methodology; the limitations of cross-sectional data apply. Most measures were calculated as averages from 2000-2005 and thus do not allow us to assess how the associations between the key variables of interest changed over time. Finally, our model was parsimonious. Adding more explanatory variables and investigating nuances through moderating effects would make a valuable contribution.

The appropriateness of using the CPIA data as a proxy for the social dimension of a country's institutional environment bears a reflective review and could also be considered a limitation of this paper. Certainly these scores have incited much criticism – deserved or not – and a rationale for their use in the present study is in order. The CPIA scores have been the target of many critiques over the years (*e.g.*, the results are not comparable over time, since more countries have been added annually), but we will present the three most prominent criticisms of the CPIA dataset and their ripostes ([Bretton Woods Project, 2006](#); [CPIA, 2005](#); [Herman, 2004](#)). First, the World Bank had been harshly criticized in the past for a lack of transparency in the process of gathering and calculating the CPIA scores. To this end, in 2006 the Bank made public for the first time its 2005 CPIA numerical ratings for each country/criterion dyad, thus assuaging its detractors' accusations that it had something to hide. Second, the World Bank's motives for gathering the data have been called into question. Some critics claim that, since the Bank uses the results of the CPIA assessment to allocate funds and distribute low-interest loans to developing countries, it may be applying pre-established neo-liberal policies that compromise the data collection process. In response to this criticism, we would argue that how the CPIA scores are applied by the Bank and other organizations lies

outside our sphere of influence. It would be a legitimate concern if the data collection were skewed, but we defer to the conclusion of an independent OECD report that states that the CPIA “is considered by many . . . to be the most carefully constructed set of governance indicators” (Arndt & Oman, 2006:40).

And lastly, the CPIA indices have been attacked because they correspond to perceptions-based measurements, that is, they are based on opinion (person-to-person interviews and other survey instruments) rather than facts-based measurements that quantify data, such as the number of anti-pollution laws in place in a country or the percentage of women in the workplace. The World Bank, in its explanation of the methodology used for the 2005 CPIA data collection, contends that *both* perceptions and facts are used to produce the measures. It maintains that the country CPIA scores

reflect a variety of indicators, observations, and judgments that are based on country knowledge originated in the Bank, analytic work or policy dialogue, or work done by partners, and relevant publicly available indicators. . . .

(CPIA, 2005: 4)

In new institutional economics terms (North, 1990), facts-based data are more representative of formal institutions (rules and regulations), whereas perceptions-based data can be categorized as more indicative of informal institutions (values, judgments, belief systems). We concur with the OECD conclusion that neither type of measure is superior and that both can potentially be complementary sources of information (Arndt & Oman, 2006:30-31). Furthermore, by measuring the perceptions of the effectiveness of regulations and policies in place in a society, the CPIA captures the essence of what matters: do they work? A case in point would be the strict anti-gun laws that are on the books in

Guatemala (although not in our sample, a developing country nonetheless).<sup>2</sup> About six thousand people were murdered in Guatemala in 2009. During the first week of March 2010, violence ended the lives of one hundred ten people, one hundred of whom were killed with firearms, thus implying that the country's tough gun laws have lax enforcement (Hernandez & Tercero, 2010). If the CPIA were to measure to what extent national anti-gun policy in Guatemala ensures minimal protection to the country's population, an assessment that includes "implemented rather than intended policy actions" (CPIA, 2005:2) would align more closely to the effectiveness of the gun regulatory regime in Guatemala than does the latter, supporting the contention that perceptions-based measures can be complementary to facts-based measures.

In light of these comments and the World Bank's detailed and transparent explanations of the CPIA's methodology (World Bank, 2010), we are confident that this dataset is an appropriate proxy, both reliable and valid, with which to examine the research question and test the hypotheses of this investigation. Although we are unaware of other empirical papers in the management or international business fields that have used the CPIA indices, this may be more attributable to a generalized exclusion of the social dimension in institutional studies (our argument throughout this paper) than to a perceived flaw in the dataset.

#### *Future research*

An increasing amount of FDI is carried out by developing countries. Cross-border mergers and acquisitions among firms in developing countries alone reached a record high of almost US\$90

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<sup>2</sup> Taken from information published by the International Action Network on Small Arms: [http://www.iansa.org/regions/camerica/guatemala\\_new\\_law09.-htm](http://www.iansa.org/regions/camerica/guatemala_new_law09.-htm).

billion in 2005 (UNCTAD, 2006:108). This is considered the fourth round of increases in outward FDI by developing and transition economies (the decades of the 1970s, 1980s, and 1990s all showed similar increases), and it begs the question: do multinational firms from developing countries have strategies for their FDI location choices that are similar to those of large multinational corporations? If so, what are the policy and practical implications of this phenomenon?

One fruitful avenue for future research in this vein would be to extend existing empirical work in this area (Filatotchev, Strange, Piesse, & Lien, 2007), discern which developing countries are contributing most or least to the unprecedented growth in FDI in the 21<sup>st</sup> century, and determine what their target countries of choice are. This could open the way to research on a myriad of management and public policy implications: how the institutional environment varies among the high-FDI or low-FDI in the various home/host developing countries; what the engine of FDI growth is (technology, services, etc.); what entry mode the multinational firms from developing countries prefer – greenfield, acquisition – and what ownership structure they tend to choose – wholly-owned subsidiaries or joint venture partnering. The choice of a local joint venture partner over a non-local (another multinational firm, for example) in itself could provide a rich testing ground that builds on other scholars' work (Steensma, Tihanyi, Lyles, & Dhanaraj, 2005).

Another empirical challenge would be to quantify and analyze other positive spillover effects that arise from pro-social policies, besides higher FDI and its accompanying benefits.<sup>3</sup> For

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<sup>3</sup>Stodder & Schroth (2004), for example, found that public health and education have a mutually reinforcing relationship with better governance.

example, are pro-social policies associated with lower levels of corruption? With higher rates of local start-ups (or levels of entrepreneurship)? With more ease of doing business for multinational firms? Scholars might investigate whether outside parties, such as nongovernmental agencies (NGOs), play a part in influencing host governments in developing countries to establish more pro-social policies.

### CONCLUSION

The present study represents a preliminary investigation. Using the pro-social measures from the World Bank's Country Policy and Institutional Assessment dataset, it examined the interdependencies between the social dimension of a host government's institutional environment and its levels of foreign direct investment. Its key finding – that social institutions matter – can serve as a point of departure for future scholarship that attempts to further disentangle the contribution of pro-social programs in defining a country's institutional context and its effects on FDI decisions. Social issues do have a role to play in firms' internationalization strategies; we need to understand more in depth what that role is.

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#### Appendix A: 59 Countries in Sample

Albania	Grenada	Pakistan
Armenia	Guinea	Papua New Guinea
Azerbaijan	Guinea-Bissau	Rwanda
Bangladesh	Guyana	São Tomé and Príncipe
Benin	Haiti	Senegal
Bolivia	Honduras	Sierra Leone
Burkina Faso	India	Solomon Islands
Burundi	Indonesia	St. Lucia
Cambodia	Kenya	St. Vincent & The Grenadines
Cameroon	Lesotho	Sudan
Cape Verde	Madagascar	Tanzania
Central Afr. Rep.	Malawi	Togo
Chad	Mali	Tonga
Comoros	Moldova	Uganda
Congo, Dem. Rep.	Mongolia	Uzbekistan
Congo, Rep.	Mozambique	Vanuatu
Djibouti	Nepal	Vietnam
Ethiopia	Nicaragua	Zambia
Gambia, The	Niger	Zimbabwe
Ghana	Nigeria	

**Appendix B: The World Bank's Definition for the Five Social Inclusion and Equity Criteria**

1. *Gender equality* reflects to what extent national policies and institutions promote equal access for men and women to human capital development and economic resources, and give them equal status under the law. Specific areas include the political participation of women, access to and completion of education, and property and inheritance rights.
2. *Building human resources* rates the extent to which national policies and the public and private sector provide access to and quality of health services, education and prevention and treatment of HIV/AIDS and other serious illnesses.
3. *Equity of public resource* use assesses whether the patterns of public spending and tax collection are consistent with poverty reduction priorities.
4. *Social protection and labor* covers government policies that ensure a minimal welfare level to the country's population through social safety nets, old-age pensions, protection of basic labor standards and government efforts in training workers.
5. *Policies and institutions for environmental sustainability* scores to what extent government policies foster the protection and sustainable use of natural resources and the management of pollution.