The Conditional Nature of Political Risk:
How Home Institutions Influence the Location of Foreign Direct Investment

Quintin H. Beazer*

Daniel J. Blake†

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Abstract

What determines whether countries' institutions attract or deter investment? Although existing theories predict that multinational enterprises (MNEs) will avoid locations where institutions cannot constrain the opportunistic behavior of public and private actors, we argue that the attractiveness of host country institutions depends on the institutions that investing firms have encountered at home. By shaping firms' practices and capabilities, home country institutions help determine the institutional environment that firms are best prepared to deal with when investing abroad. Applying this argument specifically to judicial independence, we test our predictions using multiple datasets at different levels of analysis: firm-level data on MNEs' foreign subsidiaries, data on bilateral foreign direct investment (FDI) positions, and longitudinal data on bilateral FDI flows. We find that states with independent judiciaries are particularly attractive to investment from countries also possessing independent courts. Similarly, FDI from countries with low judicial independence goes disproportionately to host countries lacking independent judiciaries.

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*Florida State University, qbeazer@fsu.edu
†IE Business School, Daniel.Blake@ie.edu

What determines whether countries' institutions attract or deter investment? A large body of research on the relationship between political institutions and investment indicates that certain institutions attract foreign direct investment (FDI) by reducing investors' exposure to political risk – the risk of financial losses from political changes that alter the probability of achieving business objectives. Across a variety of studies, there is broad agreement that political and legal institutions can create a favorable environment for investors by constraining state and private actors from reneging on their agreements, defining and protecting property rights, and reducing uncertainty about the policy environment (Li & Resnick 2003, Jensen 2008, Nooruddin 2011, Staats & Biglaiser 2012). Such arguments predict that multinational enterprises (MNEs) will invest where institutions have these risk-reducing traits and avoid locations where they do not. Yet, countries lacking these favorable institutions still attract significant amounts of FDI. Why do countries with "risky" institutions still attract FDI? Why are some firms willing to invest in unfavorable institutional environments?

To date, political scientists have typically sought to answer such questions by seeking more finely-grained sources of institutional heterogeneity. Concerning investment in non-democracies, for example, recent scholarship has helped to identify how legislatures within autocracies can encourage investment despite that regime type's perceived credible commitment problem (Wright 2008, Jensen, Malesky & Weymouth 2014). In this paper, we pursue a different line of thinking – that investing firms' differing experiences with home country institutions lead them to react heterogeneously to institutions abroad. While this insight may seem intuitive, it is underappreciated in political science. By focusing almost exclusively on the institutions of countries that are seeking FDI (*host* countries), political science research has overlooked how foreign investors' response to host institutions may depend on where those investors are coming from (*home* countries).

For example, consider how conditions at home have shaped the international investment strategies of Orascom Telecom, an Egyptian telecommunications company with overseas projects in places that others often deem too politically risky. The company's executive chairman, Naguib Sawiris, recalls his decision to invest in Algeria even though other investors were put off by the country's political instability: "I said, 'This is everyday news in my part of the world, so what's

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the big deal?'...If you come from a risky destination, then the risk is relative." (quoted in Guillén, García-Canal & Fernández-Ménendez 2015, p.192).

This paper's central claim is that the benefits or drawbacks of certain political institutions to foreign investors are not absolute; instead, whether particular institutions attract or deter FDI depends in part on the institutions to which investing firms have adapted at home. Before investing abroad, firms develop a repertoire of strategies that are tailored to protecting their interests within the context of their home country's political and legal institutions. In this way, home institutions shape firms' practices and capabilities, thereby helping to determine the institutional environments that firms are best prepared to deal with when investing abroad. If true, this argument challenges conventional wisdom in political science about FDI with its implications: "good" institutions may not be universally and equally attractive to investors, and "bad" institutions may not always be the deterrent that current research suggests.

We apply this general argument to independent judiciaries, a prominent set of institutions within the FDI literature. Autonomous and effective courts at home create incentives for firms to invest in capabilities that enable them to build strong legal positions *ex ante* and enforce those positions *ex post*. When investing abroad, such firms are inclined towards locations where judicial institutions allow them to leverage those capabilities and put off by countries with less reliable judicial institutions. Conversely, home countries without independent courts necessitate that firms learn to protect their business interests using alternative, informal strategies that do not rely on the legal system; for such firms, weak and ineffective courts in a host country do not represent an unusual obstacle so much as business as usual. This conditional logic predicts that firms from countries with low judicial independence should be more likely to invest in host countries with low judicial independence than firms from countries with high judicial independence.

To provide a comprehensive and compelling test of our claims, we leverage data from multiple levels of analysis and with different strengths and weaknesses. First, using firm-level data on MNE subsidiary formation, we show that MNEs from countries with little judicial independence are significantly more likely to establish a subsidiary in "risky" judicial environments than companies from countries with highly independent courts. Then, to confirm that this conditional relationship

also appears in aggregate investment patterns, we analyze two different cross-national datasets: cross-sectional data with extensive geographic coverage on bilateral FDI stocks as well as longitudinal data with more limited coverage on bilateral FDI flows. In both datasets, we again find that the relationship between host judicial institutions and FDI depends upon the home country's institutions. High judicial independence in a host country is associated with greater levels/flows of FDI from home countries with higher levels of judicial independence, even controlling for rival economic explanations and well-documented patterns of global investment.

Our research makes several contributions. Foremost, it underscores that political risk is a function of not only host institutions, but also firms' capabilities to operate successfully under those institutions. This means that the benefits and drawbacks of countries' institutions to international investors are not uniform or universal, as existing political science research implicitly assumes, but conditional on other factors. Secondly, in calling attention to MNEs' home institutional environment as one such factor, we depart from political science research on FDI, which to date has focused almost exclusively on *host* countries, with little discussion of investors' *home* environment. This theoretical move helps to highlight the growing presence of FDI from the developing world and provide a welcome counterbalance to the dominant theories and data that disproportionately emphasize developed-world experiences. Finally, while FDI research in political science often portrays firms narrowly, as cautious observers that respond homogeneously to institutional protections and risks, this research reminds scholars that firms can and do adopt a wide range of actions to work within their non-market environment.

Institutions & Foreign Direct Investment

In recent decades, many countries have sought to attract FDI to capture its potential economic benefits, such as growing capital stock (Jensen 2006), increased employment and export activity (Markusen & Venables 1999, Jensen 2003), and higher wages (Pandya 2010, Caves 2007). Commensurate with the heightened interest in FDI, social scientists have focused particularly on how host states' institutions shape investment decisions by generating or mitigating risks for foreign investors. For example, scholars claim that firms avoid investment locations where formal institutions cannot

credibly protect actors against expropriation by private actors or by the state itself. Instead, firms will prefer locations with well-functioning institutions, such as an independent judiciary, that can check opportunistic officials and allow businesses to defend their contracts and property rights in a timely, predictable manner (North 1990, Levy & Spiller 1994, Staats & Biglaiser 2012). Empirical research has found broad support for such arguments, showing that states with institutions that constrain political leaders and ensure the protection of property rights tend to receive more direct investment (Stasavage 2002, Li & Resnick 2003, Jensen 2006).

Despite the consensus that certain political and legal institutions should attract foreign investors, we observe that many countries continue to attract significant levels of FDI despite lacking such institutions.[1] One explanation is that existing arguments are overlooking subtler aspects of countries' institutional variation that is important. Along these lines, recent scholarship has examined increasingly specific institutional arrangements, such as legislatures within autocratic regimes (Wright 2008, Jensen, Malesky & Weymouth 2014) or coalition governments within democracies as credible constraints on policy change (Nooruddin 2011). Separate from issues of institutional heterogeneity, however, FDI might also flow to countries with "undesirable" institutions for a second, underappreciated reason: investors themselves are more heterogeneous than generally acknowledged in the literature.[2] In the sections that follow, we develop this insight to argue that the effect of host countries' institutions on FDI location depends upon MNEs' past experiences at home with political and legal institutions.

Growing Diversity among FDI Home Countries

The near-exclusive focus of political science's FDI research on *host* country institutions stems from certain institutional idiosyncrasies of the OECD economies that FDI scholars have tacitly assumed to be MNEs' home locations.[3] First, firms from the OECD countries have home institutions that

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[1]This remains true even after controlling for important FDI attractors like natural resources or large market size.

[2]The few exceptions within political science that do consider investor heterogeneity have focused on the liquidity of firms' assets (Kerner & Lawrence 2014), diaspora investors (Graham 2014), or shared nationality between investors and disputants with host governments (Wellhausen 2015).

[3]While the Organization for Economic Co-operation and Development (OECD) technically includes a handful of emerging-market countries, we are referring in this paper to the 29 wealthy countries that sit on the OECD's Development Assistance Committee. This definition excludes Chile, Estonia, Israel, Mexico, and Turkey.

are unusually effective at constraining political opportunism and protecting property rights; this implies that any potential host location could only be compared to a reference point that is close to the theoretical ideal. Secondly, these favorable institutional conditions are relatively homogeneous across OECD countries. Consequently, there would be little variation to spark researchers' curiosity in home country effects.

Table 1: **Direct Investment from Developing Countries, 1970-2010**

Year	*Billions of USD*	*% of World Total*
1970	0.05	0.36
1980	3.19	6.19
1990	11.91	4.93
2000	137.39	11.15
2010	388.15	29.33

Note: Data from UNCTAD.

Yet, the proportion of FDI coming *from* the developing world has risen dramatically over the last two decades, as Table 1 makes clear. In the process, the global set of MNE home countries has grown increasingly diverse. With the emergence of MNEs from developing and emerging markets, we now observe significant institutional variation across foreign investors' home countries, including places where institutions are often too unreliable or weak to provide many protections to economic actors. This observed variation in home country institutions should encourage political scientists to revisit our theories.

Why Home Institutions Matter

To be successful enough to invest abroad, firms must first develop strategies and cultivate resources that allow them to thrive under their home country's political and legal institutions. We argue that the repertoire of skills and practices they develop influences managers' decisions regarding the institutional environments that they are prepared to deal with when investing abroad. In this manner, the same set of host institutions can prompt diverging reactions among investors due to firms' different institutional backgrounds. We develop this argument's logic here, then generate

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testable predictions in the next section by applying this theoretical framework to a set of prominent institutions from the FDI literature: independent judiciaries.

At the microlevel, political science research on FDI considers a relatively narrow slice of firm behavior regarding host institutions and investment decisions. However, if companies have evolved to become MNEs, they have a history of successful behaviors and strategies that are attuned to their domestic institutions (Kostova 1999, DiMaggio & Powell 1983, Kostova, Roth & Dacin 2008). In particular, successful firms invest heavily in practices designed to manage their exposure to risks and opportunities from political and legal institutions. In some environments, firms develop practices aimed at protecting their interests through lobbying, political connections, or placing candidates up for office (Grossman & Helpman 1996, Fisman 2001, Gehlbach, Sonin & Zhuravskaya 2010, Szakonyi 2016). Alternatively, unresponsive or ineffective government institutions may encourage firms to seek to protect investments by integrating into professional networks (McMillan & Woodruff 1999*a*), hiring extralegal organizations (Johns & Wellhausen 2016), or employing bribery and corruption (Vishny & Shleifer 1993). Moreover, firms learn and become more successful through experience (e.g. Levitt & March 1988, Barkema, Bell & Pennings 1996); thus, firms' home institutions shape what they do and, through experience, what they are able to do well.

Drawing from management research, we argue that the context-specific strategies and practices that firms adopt to navigate the political and legal institutional environment at home should affect their decisions about where to invest abroad. When investing overseas, firms must decide how much to replicate their familiar practices from home within their new subsidiaries and how much to adapt by replacing these practices with new patterns of behavior that better suit the local environment (Zaheer 1995). For multiple reasons, firms have strong incentives to replicate whenever feasible as they enter new locations. Adaptation is often costly and complicated, requiring managers to learn new skills and establish new ways of conducting business (see Cuervo-Cazurra 2006). Such changes can be difficult to realize, as existing practices become "institutionalized" within firms (Oliver 1997, Scott 1987). Often, firms contemplating adaptation also face high uncertainty about their ability to select the appropriate practices and implement them successfully.

In contrast, replicating allows firms to harness existing practices that they know have worked

well in the past (Rosenzweig & Singh 1991).[4] For replication to be profitable, however, MNEs require a host environment where their existing strategies and practices are likely to succeed. When home and host countries reward different behaviors, this is less likely (Ghemawat 2007). In such cases, firms face pressures to either adapt more to the host environment (Bartlett & Ghoshal 1989, Jensen & Szulanski 2004) or else seek an alternative investment location.

Characterizing investors' options thusly clarifies that, contrary to standard political science models, investors do not evaluate host institutions in a vacuum; MNEs must also consider their operations' compatibility with such institutions.[5] For any given firm, some host institutions make it easier to replicate the strategies that have succeeded at home while other host institutions require firms to adapt or replace those home practices that are ill-suited to the new environment. All else equal, firms seek to minimize the need for potentially difficult adaptations and invest where they believe their assets and practices are better suited to the institutional environment.[6] All together, this offers one potential answer for why we observe FDI in countries with "risky" institutions: some investors are better prepared to operate there because they have already developed capabilities and practices for dealing with unreliable institutions at home.

We note that other research communities have been more attuned to home countries' influence in international investment. For instance, some management research focuses on the role of distance in firms' international expansion decisions, although "institutional distance" scholarship has mainly studied cultural and regulatory differences (for a review, see Berry, Guillén & Zhou 2010).[7] Our argument intersects most closely with Holburn and Zelner (2010), which argues that firms from countries with weak political constraints on policy change will seek out host countries with weak constraints because they have developed strong political capabilities for influencing policy-making.

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[4]Proctor & Gamble's approach during the 1980s was particularly zealous, aiming explicitly for each foreign subsidiary to be an "exact replica of the United States Proctor & Gamble organization" based on the assumption that "exactly the same policies and procedures which have given our company success in the United States will be equally successful overseas" (Bartlett & Ghoshal 1989, p.38).

[5]While we argue that home institutions shape firms' subjective assessments of risk, we do not claim that such assessments are always accurate or that this decision-making prevents unexpected problems or guarantees profit.

[6]To be sure, all foreign investment requires some degree of adaptation, and firms can and do adapt successfully when investing abroad. Our argument is that firms will more strongly prefer locations with lower pressure to adapt and greater ease of replication.

[7]One exception is Cuervo-Cazurra and Genç (2008), which uses institutional "familiarity" to explain the relative prevalence of developing-country MNEs in 40 of the least-developed countries.

Besides having a separate substantive focus, we do not argue that firms develop *stronger* capabilities when exposed to weak institutions at home; instead, we argue that firms develop *different types* of capabilities that are appropriate to their home country institutions, whether strong or weak. Moreover, our framework allows for the possibility that stronger institutions are not universally favorable – some firms may find "good" institutions less attractive because they lack the experience and capabilities to leverage those institutions to their advantage.[8]

We acknowledge that, in addition to home experience, firms may gain experience in foreign countries that could influence their investment decisions (Delios & Henisz 2003). For firms to leverage international experience, they need an organizational architecture to effectively incorporate these diverse experiences and disseminate the practices throughout the MNE (Jonsson & Foss 2011). Yet, not all MNEs have such an architecture, and it requires time and resources to develop. Thus, if international experience does have similar effects, we concur with Holburn and Zelner (2010) that home experience still probably represents "a more fundamental influence" on developing capabilities for managing institutional risks (pp.1292-1293).[9]

Judicial Independence & Heterogeneous Business Practices

To illustrate more concretely how home institutions condition host institutions' effects on FDI, we apply this theoretical framework to a set of institutional arrangements that are prominent within FDI studies: judicial independence.[10] Social scientists argue that independent judiciaries protect economic actors from host states by constraining government backsliding on policy commitments, curbing attempts to illegally expropriate firms' property rights, and ensuring the fair application of regulatory rules to foreign entities (Levy & Spiller 1994, Delios & Henisz 2003, Staats & Biglaiser

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[8]We differ empirically, too. Holburn and Zelner study a single industry (electricity generation) for a limited number of home countries (28), only a handful of which are in the developing world. In comparison, our data includes multiple levels of analysis, multiple economic sectors, and a broad array of home countries (more than 150 in one dataset).

[9]In the empirical analysis, we do control for firms' international exposure to account for experience and capabilities gained through international operations. Results are not sensitive to this variable's inclusion.

[10]Following Rios-Figueroa and Staton (2012), we define the dimensions of de facto judicial independence as: 1.) *autonomy*, meaning that judges rule based on their preferences and assessments, without undue sway by government or non-governmental actors; and 2.) *influence*, meaning that judicial decisions are enforced "even when political actors would prefer not to comply" (p.4).

2012).[11] Separately, scholars also suggest that independent judiciaries may encourage FDI by enforcing contracts and securing MNEs' property rights with respect to other *non-state* actors in the host country (Li & Resnick 2003, Staats & Biglaiser 2012). Thus, independent courts may make dealing with domestic suppliers, clients, and partners more predictable – an important concern even for MNEs who feel confident that their home government or an investment treaty can protect them from a predatory host government.

Crossnational research on FDI provides evidence that countries with institutions that encourage greater judicial independence have higher FDI inflows (Li & Resnick 2003, Henisz 2000, Stasavage 2002, Jensen 2006, Delios & Henisz 2003). These results are supported by more targeted studies seeking to tease out the specific effects of independent and impartial courts on FDI (Staats & Biglaiser 2012). However, despite foreign investors' assumed preference for independent judiciaries, countries with weak judicial independence continue to attract non-trivial amounts of FDI. Our argument suggests that this is at least partially because firms from different institutional backgrounds may differ significantly in the extent to which they view independent courts as necessary for securing their property rights and facilitating economic exchange.

Consider how economic actors protect their interests when they can resolve conflicts or prevent losses via independent courts. Using those courts effectively, either to challenge government actions or receive compensation for broken contracts, requires that firms invest in developing resources and practices that enable them to build strong legal positions *ex ante* and enforce those positions *ex post*. Competitive companies typically rely heavily on cooperation among their legal, technical and managerial divisions to design contracts that protect their interests effectively and impose costs on parties who abandon their commitments (Bagley 2008, Poppo & Zenger 2002). Such coordination creates firm-level expertise in contract design that grows over time, through multiple episodes of contracting and practice managing contractually-governed relationships (Mayer & Argyres 2004, Ryall & Sampson 2009, Argyres & Mayer 2007).[12] Indeed, in such environments, inferior legal

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[11]The ability of bilateral investment treaties (BITs) to reduce such investor-state confrontations is debated (Neumayer & Spess 2005, Kerner & Lawrence 2014). Given that the costliness of international ligation stops many legitimate cases from being pursued (see Franck 2014), firms' capacity to navigate hosts' legal environment and avoid such conflicts should still matter greatly to even those MNEs with guaranteed access to international arbitration by a BIT.

[12]According to Argyres and Mayer (2007), this also means that hiring outside legal consultants will not be a

capabilities make a firm vulnerable to those who understand how to design contracts and use the legal system against them. Consequently, home countries with high judicial independence produce MNEs that have been incentivized to develop robust practices around building and enforcing legal protection of their activities (Bagley 2008).

In contrast, where judicial independence is low, firms have few incentives to commit resources to developing legal capabilities since courts cannot reliably constrain public and private actors from reneging on commitments. Instead, firms in such locations eschew legalistic approaches and develop alternate practices to protect against others' opportunistic behavior. For instance, firms may try to minimize vulnerabilities by avoiding credit, requiring upfront payments, or internalizing a greater proportion of their operations within the firm (see Johnson, McMillan & Woodruff 2002, Acemoglu, Johnson & Mitton 2009, Dorobantu, Kaul & Zelner 2016). Alternatively, firms can seek to resolve conflicts or obtain favorable treatment by using bribery. This requires firm managers learn to engage in corrupt activities effectively, developing routines and relationships that allow them to bribe the right person in the right way (Cuervo-Cazurra 2006). Likewise, if economic actors understand the political arena and cultivate key relationships, they can seek refuge in political patronage, requesting friendly government actors to intervene to enforce contracts or manipulate rules in their favor (Li & Resnick 2003, Holburn & Zelner 2010). Informal commitment devices are also an option for firms with experience in building professional networks and using informal institutions that leverage expectations of future exchange to limit contractual noncompliance and protect property rights (Greif 1993, McMillan & Woodruff 1999b, Kumar, Siddique & Hedrick-Wong 2005).

Enterprise survey data from the World Bank provide an empirical window into the prevalence of different practices under different institutions.[13] For example, in Figure 1's top panel, we see that, where judicial independence is lacking, firms are more likely to try to "get things done" by using bribery. Similarly, Figure 1's bottom panel shows that firms operating amidst low judicial independence hedge against contract noncompliance by requiring a greater percentage of payments before or at delivery, rather than afterwards. Such evidence helps to substantiate the theoretical

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comparable substitute since contract design capabilities are a firm-level attribute, and not "simply a matter of hiring the appropriate lawyers, either internally or through the retention of outside counsel" (p.1072).

[13]Roughly 90% of survey respondents are domestic enterprises. The data do not provide information on home countries of foreign firms nor the overseas investment locations of any respondent.

claim that firms in different judicial environments choose different strategies to solve their problems and protect their interests.[14]

The development of institutionally-appropriate strategies helps to explain how home judicial institutions condition the effects of host judicial institutions on FDI location. If MNEs from countries with high judicial independence have invested in capabilities that rely on the presence of effective courts, then we should expect those MNEs to prefer hosts with high judicial independence because these environments offer better opportunities to use these capabilities and replicate their home operating practices. Conversely, MNEs from countries with low judicial independence do not develop business models that rely on independent courts. Because such firms have not invested in legal resources at home, they are potentially disadvantaged by host environments that reward strong legal skills. This does not mean that firms from risky home environments do not recognize or value the potential benefits that FDI scholars attribute to independent judiciaries. Rather, our argument implies these firms will find those benefits less attractive than regularly supposed and often outweighed by the costs of adapting to a different style of business: in-house legal counsel, frequent lawsuits, formal contracting, large legal expenditures, etc.

Of course, whether independent host courts are a net positive or net negative factor for firms from countries with low judicial independence is difficult to predict since it depends upon whether firms' individual costs of adapting to a new, legalistic environment are either totally or only partially offset by the perceived benefits. However, we can make a *comparative* prediction: because their expected benefits are undercut by concomitant costs, independent judicial institutions will not be as attractive to firms from home countries where judicial independence is lacking. Thus our main hypothesis – we expect that firms from countries with high levels of judicial independence will be more likely to invest in countries with high levels of judicial independence than firms from countries with low levels of judicial independence.

We also expect the inverse to be true: firms from countries with low levels of judicial independence will be more likely to invest in countries with low judicial independence than firms from countries with high levels of judicial independence. The robust legal repertoires developed to com-

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[14]Please see the appendix for a more rigorous test of this important causal mechanism behind our argument. These patterns persist even controlling for additional firm, sector, and country-level traits using multilevel linear regression.

Figure 1: Firms' Strategies in Weak Judicial Environments: Bribery and Payment before Delivery

Amount of Bribes Paid to 'Get Things Done'

Composition of Firms' Sales, by Time of Payment
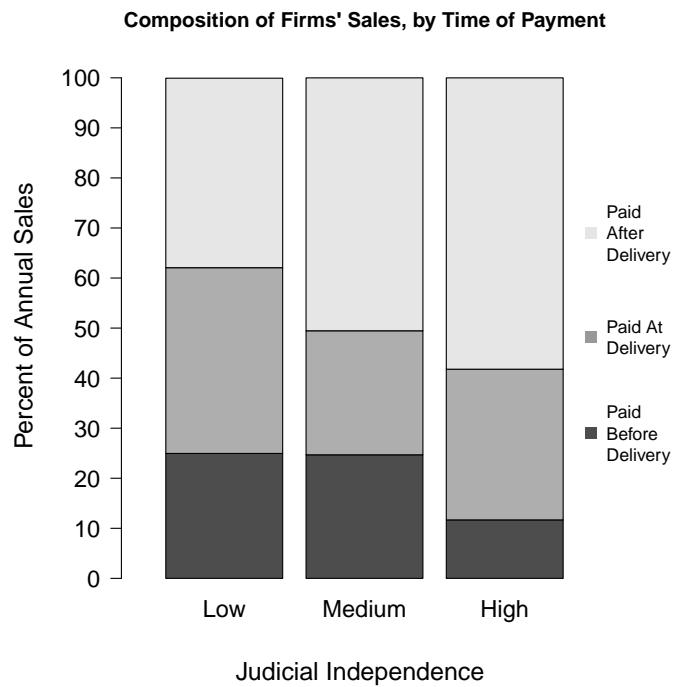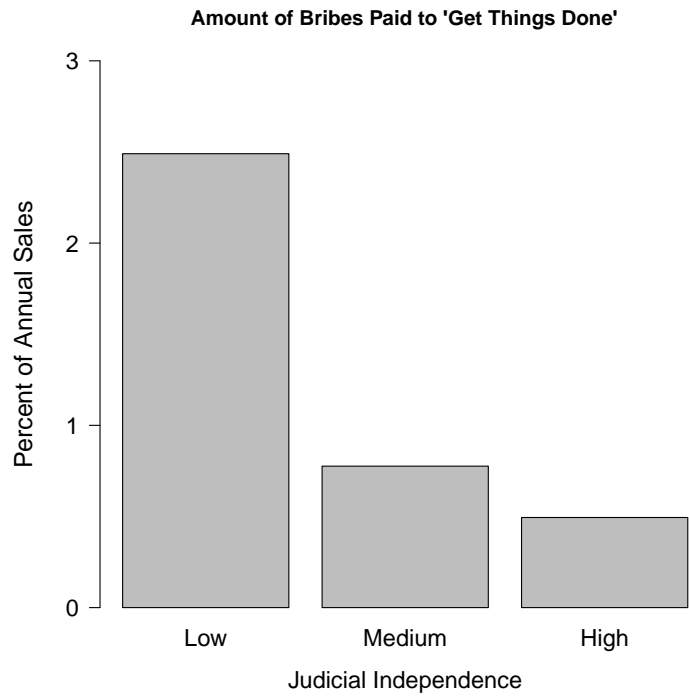
Note: Data from the World Bank Enterprise Surveys (2006–2011), using responses from 33,366 firms in 80 countries. Data on judicial independence from Linzer and Staton (2015).

pete under independent courts are ill-suited to environments where judicial independence is low and informal practices play a major role in business dealings. For example, Kumar et al. (2005) detail how Singaporean firms' more legalistic approach has hurt their performance within the more informal setting of Chinese markets.[15] One Chinese manager in a Sino-Singapore joint venture remarks: "Singaporeans are very canonical and get used to dealing in transactions by contracts...[but] There exist many gray areas because of the leakages of China's policies and institutions, which they [the Singaporeans] simply cannot accept" (Kumar, Siddique & Hedrick-Wong 2005, p.49). Consequently, Singaporean firms struggle to develop close relationships with Chinese companies, operate at higher costs, and find themselves disadvantaged relative to local Chinese companies (Kumar, Siddique & Hedrick-Wong 2005).[16] Thus, for firms who are oriented to independent courts at home, the difficulty of securing property or managing trading relationships without independent host courts creates obstacles to competitiveness and success that should deter investment.

Conversely, successful firms from home countries with low judicial independence have experience protecting themselves using non-court strategies, such as extralegal influence or carefully-structured exchange relationships. These home-grown skills – knowing how to find trustworthy partners, design strategies that do not depend on contracts, or bribe effectively – are likely to be useful elsewhere when judicial independence is also lacking, even when those host environments differ appreciably from firms' own "risky" home.

For example, while Western executives in Moldova share "horror stories in which bribery turned into extortion," Turkish investors' familiarity using gray activities as a risk management tool enabled Turkish firms to enter the market and avoid contractual entanglements with the Moldovan

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[15]Firms from many other countries have also found that turning to courts, while likely to work at home where judicial independence is higher, can be frustrating in China's judicial environment (Wang 2015). For example, in 1997 when Kimberley-Clark found that a local manager was diverting materials away to a rival factory, it was unable to get the local authorities in Handan province to take action because the manager involved had considerable influence with local political officials (Roberts 1997). Given the ethnic, linguistic, and cultural ties between Singapore and China, however, the experience of Singaporean investors is particularly illuminating. Having developed under distinct institutional conditions, Singaporean firms clearly adopt different, more legalistic approaches than Chinese firms and must overcome hurdles when operating in China (Kumar, Siddique & Hedrick-Wong 2005).

[16]Adaptation challenges also arise in the other direction. According to one American lawyer who worked for a Russian metals mogul for many years, the inability to adapt to Western business practices and deep skepticism of legal institutions are primary reasons for Russian oligarchs' poor track record in OECD countries. Although their companies are highly-skilled at using personal ties and political manuevering, this business model has not traveled successfully to the more rule-driven, contract-based environments of the EU and US (author interview, Moscow, June 2015).

government (Wellhausen 2015, p.169). Likewise, Mexican telecommunications firm América Móvil became the leading player in wireless telecommunications in Latin America by pioneering and then exporting a prepayment business model suited to environments where enforcing contracts is difficult (see Casanova & Fraser 2009). Compared to U.S. operators' traditional reliance on service contracts with customers, which presume legal institutions will ultimately enforce agreements, América Móvil's prepaid model eliminates fraud and nonpayment of bills – risks that run high in the absence of reliable judicial institutions. Of course, having no contracts also presents problems in the form of low customer loyalty, which América Móvil learned to combat by investing in leading-edge technology and aggressive marketing (Casanova & Fraser 2009). The ease of replicating this home-grown model in other environments also characterized by weak courts has allowed América Móvil to expand aggressively to become the largest provider throughout Latin America; according to the company's founder, Carlos Slim: "We are the ones that understand pre-paid the best" (Wright 2009).

Possessing capabilities and strategies that work well under low judicial independence might affect MNEs and their investment decisions in multiple ways. In the strongest version, MNEs with such skills could seek out "risky" locations since the ability to replicate familiar strategies and skills might be a competitive advantage over competitor MNEs from high judicial independence countries. Alternatively, such MNEs may simply be less deterred than their developed-world competitors by the perceived challenges of doing business under hosts' captured or ineffective courts.[17] Either way, when host judicial institutions are weak, our theoretical framework expects that MNEs from countries with low levels of judicial independence invest at higher rates than MNEs coming from countries with high levels of judicial independence. Thus, while prevailing arguments predict that foreign investors should avoid investing where judicial institutions lack independence, our theoretical framework indicates that the (un)attractiveness of countries' judicial institutions depends partially on firms' home judicial environment.

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[17]Given the current state of theory regarding firm-level preferences, we lack a principled way to privilege one theoretical explanation over the other. Ideally, experimental or survey studies could explore these pathways that are effectively observationally-equivalent in our data. This exciting possibility for future research is outside the present study's scope.

Empirical Analysis

I. Firm-level Foreign Ownership Data

We begin testing our argument's empirical predictions using firm-level data on foreign subsidiary incorporations by multinational enterprises during the period 2006-2011. We collect the foreign subsidiaries data from the Orbis corporate ownership database, including in our dataset all multinational firms in the database that established at least one foreign subsidiary during the study period and met minimal criteria on size and industry (i.e., no small firms, no banks or other financial institutions).[18] This yields a baseline sample of 3,871 parent firms with new subsidiaries in 113 host countries. To analyze firms' decision to invest in some potential host locations but not others, our unit of observation is the firm-potential host country-dyad.

Data constraints on firm-level FDI have typically pushed scholars studying political institutions and firm investment decisions to focus on single sectors or industries (e.g. telecommunications or electricity utilities) or on MNEs from a particular home country (typically the U.S., Japan, or Spain) (e.g. Delios & Henisz 2003, García-Canal & Guillén 2008, Holburn & Zelner 2010). In contrast, our dataset has broad geographic and sectoral coverage, including MNEs from 63 different home countries and across many industries.[19] Accordingly, this sample provides the variation in home states' institutions that we need to test our conditional argument. We note, however, that firms from OECD countries are more heavily represented in the Orbis database, and our dataset reflects this, containing roughly ten firms from OECD countries for every developing-country MNE. Additionally, Orbis does not systematically collect longitudinal data regarding ownership, but instead updates and overwrites companies' information on a rolling basis.[20] Consequently, we treat the data as cross-sectional, representing a snapshot of MNEs and their foreign subsidiaries incorporated during the period of 2006-2011. Fortunately, although incapable of revealing temporal dynamics, these

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[18]We drop all firms – parent and subsidiary – in tax havens because tax-haven activities typically do not reflect genuine investment. Likewise, we also drop these countries from the data in subsequent analyses. Empirically, however, our results do not change meaningfully if tax havens are included. For greater details on sampling parent and subsidiary firms from Orbis, please see the appendix.

[19]Measured at the NAICS 2-digit level, our sample includes MNEs from 24 sectors.

[20]So although dates of incorporation remain fixed, firms in the database may see their ownership information change and overwritten at different points in time. We extracted the records for our sample from Orbis in 2013.

data are still well-suited to our main empirical goal: testing whether firms' propensity to invest in more or less risky locations is related to their home countries' institutional profile.

Our dependent variable is subsidiary incorporation by multinational firm i in foreign country j during the time period 2006-2011. This dichotomous variable takes a value of 1 if a firm establishes a subsidiary in its dyadic host country partner between 2006 and 2011 and a 0 otherwise.[21] While incorporation data do not describe investment size or firms' commitment to ongoing projects, establishing a subsidiary does represent a meaningful decision to engage in economic activity within a given host. Furthermore, as incorporation is a single, observable act that is comparable across contexts, this measure avoids the problems of inconsistent reporting standards and patterns of round-tripping that sometimes afflict aggregate FDI data measures (see Kerner 2014). Our baseline sample contains 10,409 instances of incorporation.

To measure home and host judicial independence, we use the Latent Judicial Independence (LJI) scores from Linzer and Staton (2015). These measures are derived from item response theory (IRT) models that infer countries' underlying *de facto* judicial independence by leveraging multiple existing, yet imperfect, cross-national indicators as observable manifestations of that latent trait.[22] LJI scores are continuous and bounded between 0 (completely dependent) to 1 (completely independent) and exist for all countries in our sample. The main coefficient of interest for our analysis is the interaction between home and host LJI measures. Before interacting the variables, we mean-center them so that the constituent terms' coefficients report home/host LJI's relationship with subsidiary incorporation when the other is at its average value. We measure this and all country-level covariates in 2005, the year before our observed investment period begins.

In our analyses, we control for certain institutions that are associated with judicial independence and linked to investment location decisions by existing research. First, we include the host country's POLCON III measure of political constraints. This measure ranges continuously from 0 to 1 and attempts to capture the extent to which formal political institutions constrain changes to

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[21]Very few firms in the data open multiple subsidiaries in a given country during our investment window, so we lose little information by treating single or multiple subsidiaries as equal investments.

[22]Assuming that firms care more about how legal institutions work in practice rather than on paper, we favor this *de facto* measure over *de jure* measures. For technical details behind the latent measures and their estimation, see Linzer and Staton (2015).

existing economic policies (Henisz 2002).[23] Second, to account for regime type's potential influence on investors, we include a dichotomous indicator of host democracy from Cheibub, Gandhi, and Vreeland (2009). Prominent political science arguments link host countries' political constraints and democratic institutions to better investment conditions, predicting positive coefficients for host-country democracy and political constraints (Henisz 2002, Jensen 2006). To the extent these variables soak up variance in our main variable of interest – judicial independence – controlling for them provides a more conservative test of our argument.

We also control for additional factors that may correlate with firms' investment decisions and countries' institutional environment. These controls include variables from gravity models of FDI, including home-host trade (in constant U.S. dollars), the level of development (GDP per capita, logged) of both home and host states, the host's economy size (GDP in constant USD, logged), and total FDI inflows into the host.[24] We also include economic growth (percentage growth in GDP per capita) in the home country to account for low domestic growth "pushing" firms to seek markets elsewhere.

It is possible that MNEs simply may prefer host countries with similar sociocultural conditions (Ghemawat 2007). We account for cultural similarity with dyadic indicators for shared official language or shared colonial history. Similarly, we control for geographic distance between home and host countries, as economic exchange typically decreases with distance.[25] Having access to international arbitration may alter firms' concerns about hosts' domestic judicial institutions; accordingly, we also control for firms' home country having a bilateral investment treaty (BIT) with the potential host. Finally, we include firm-specific variables that might affect firms' willingness to invest abroad: a measure of the MNEs total assets (logged), a logged count of the MNE's age (in years), and, to account for firms' internationalization, a count of countries in which the firm already operates.

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[23]Using the POLCON III index (instead of POLCON V) enables us to better isolate the effect of independent judiciaries separate from political constraints, because POLCON III does not include judicial constraints on policy making.

[24]Trade data is from the *Correlates of War* data set (Barbieri, Keshk & Pollins 2008) and the remaining economic variables are from the World Bank's *World Development Indicators*.

[25]Alongside the extra economic interactions, these cultural measures may also help mitigate concerns that cultural similarities might drive both investment choices and institutional similarity. Data on geodesic distances, colonial history and common language are from CEPII: http://www.cepii.fr/anglaisgraph/bdd/distances.htm.

We estimate the independent variables' relationship to firms' investment location decisions using multilevel logit models. Multilevel models' flexibility in modeling nested and cross-nested relationships makes this a natural choice for analyzing our complicated data structure where firms are nested within both countries and industries (Gelman & Hill 2007). Moreover, since our country-level variables repeat thousands of times across firm-host dyads, our observations exhibit tremendous amounts of cross-nested clustering that unless corrected for would artificially shrink our standard errors towards zero. In addition to helping account for unobserved heterogeneity, using random intercepts within our models for these groups adjusts for the nonindependent errors across repeated observations and helps to ensure that our standard errors are properly large.

Results

For clarity, Table 2 presents results for only the main variables of interest from our firm-level statistical analyses; estimates for all other included covariates appear in Table A5 in the appendix. Column 1 reports coefficient estimates from a model including only home LJI, host LJI, their interaction, plus varying intercepts for home and host countries. Column 2 includes all control variables and adds random intercepts to adjust for industry-level heterogeneity. We consider this to be the main model specification. Column 3 adds additional intercepts for unobserved heterogeneity in reoccurring home-host dyads. The last column reports model estimates after controlling for host/home interactions for both economy size and development. These additional interactions are included to address concerns that independent judicial institutions merely proxy for key features of economic development, such as levels of human capital or competitiveness. In this view, a positive home/host interaction of judicial environments might simply reflect productive (Western) firms seeking large markets or skilled labor in other rich countries; similarly, firms from poorer countries might have worse human capital or lower productivity and are thus only able to compete within less desirable locations. Including home/host interactions for both development and size of the economy helps to control more directly for these economic complementarities that could mislead about the underlying nature of the conditional relationship between home institutions, host institutions, and investment location.

Table 2: **Cross-sectional Firm Data: Multilevel Logit Models of Foreign Subsidiary Incorporation between 2006-2011**

DV: NEW FOREIGN SUBSIDIARY dummy; 1 = subsidiary established	(1)	(2)	(3)	(4)
JUDICIAL INDEPENDENCE *LJI latent scale (0-1), mean-centered*				
HOME × HOST	1.918***	2.138***	2.873***	1.944***
	(0.308)	(0.394)	(0.545)	(0.439)
HOME	−0.317**	−0.606***	−0.895***	−0.556***
	(0.160)	(0.204)	(0.263)	(0.209)
HOST	5.078***	3.699***	3.832***	3.694***
	(0.347)	(0.866)	(0.788)	(0.947)
POLITICAL CONSTRAINTS (HOST) *POLCON scores, ranging 0 to 1*		0.568	0.375	0.571
		(0.807)	(0.729)	(0.847)
DEMOCRACY (HOST) *dummy, 1 = dem.*		−0.119	−0.068	−0.120
		(0.393)	(0.371)	(0.401)
GDP PER CAPITA: (HOME × HOST) *constituent terms also in model*				0.011
				(0.010)
GDP, LOGGED: (HOME × HOST) *constituent terms also in model*				0.001
				(0.006)
Number of Observations	398,508	345,709	342,220	345,709
Number of Host Countries	103	99	99	99
Number of Home Countries	62	56	56	56
All Control Variables	No	Yes	Yes	Yes
Sector Intercepts	No	Yes	Yes	Yes
Dyad Intercepts	No	No	Yes	No

Note: Selected coefficient estimates from multilevel logistic regressions modeling parent firm's decision to open a foreign subsidiary in a given host country. All models include random intercepts for home and host countries. In addition to those variables listed in the table; Models (2) through (4) also include controls for dyadic trade between countries, home & host GDP per capita, bilateral investment treaties, size of host economy, total FDI inflows to host, home economic growth, common language, shared colonial history, firms' age, and the number of countries in which firms already operate. Model (4) includes the interactions of home/host GDP per capita and economy size, as well as their relative constituent terms. To save space, coefficient estimates for control variables presented in the supplementary appendix. Standard errors in parentheses; *** indicates $p \leq .01$, ** indicates $p \leq .05$.

Figure 2: Marginal Effects of Host Judicial Independence on Foreign Subsidiary Incorporation
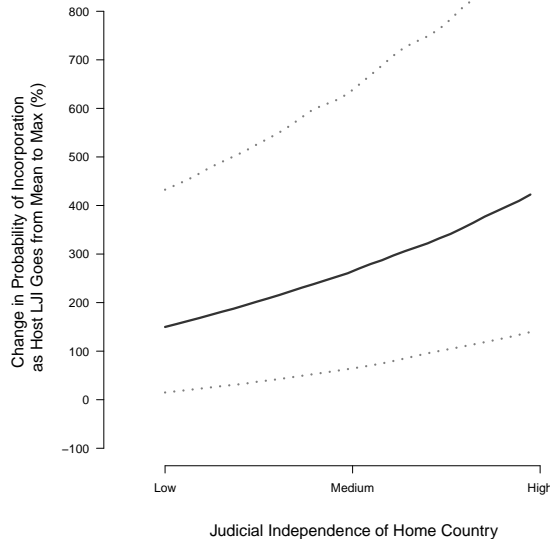
Note: Plot based on coefficient estimates from column 2 in Table 2. Bands represent 95% confidence intervals, calculated via simulation.

Is there evidence that firms' home judicial institutions condition the relationship between host judicial institutions and MNE investment? Table 2's results indicate that there is. Across all models in Table 2, the coefficient estimates on the interaction between home and host LJI scores are positive and statistically significant, as predicted by our argument. This result implies that increased judicial independence in host countries does not affect all firms similarly; instead, the attractiveness of "good" judicial institutions depends in part upon MNEs' home institutional environment. Higher levels of host LJI correspond to larger predicted probabilities of subsidiary incorporation for firms from high-LJI home countries than for firms from low-LJI home countries.

Figure 2 demonstrates the estimated change in predicted probability of opening a subsidiary when we increase host LJI for firms at various values of home LJI.[26] When firms' home courts have minimum independence,[27] improving a host's LJI from that of Romania or Bulgaria to levels found

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[26]Marginal effects are based on simulations holding all continuous covariates at their means and all discrete covariates at their medians.

[27]Home countries in the lowest decile LJI include Kazakhstan, Malaysia, Egypt, Venezuela, Bosnia, and Saudia Arabia.

in Iceland, Japan, or Australia (sample mean to the max) increases the predicted probability of investment by 150% (from 0.008 to 0.020). In these data at least, independent host courts remain a net positive for firms from low-LJI homes. In contrast, the corresponding change in predicted probability is nearly three times larger (420%; from 0.005 to 0.026) if the firm comes from a country where courts have maximum independence.[28] Consistent with our argument, this evidence suggests that independent host courts are much more attractive to firms from high-LJI countries than to firms from low-LJI countries.[29]

This analysis also provides insights into who invests in places with imperfect institutions. The constituent term for home judicial independence has a negative and significant coefficient, suggesting that when host judicial independence is the mean, firms from higher-LJI homes are less likely to invest. In other words, when judicial institutions are less than ideal, the firms most likely to invest are those MNEs that deal with imperfect courts at home. Such findings support our claims about the conditional nature of firms' responses to institutional risk.

In addition to Table 2's main findings, we discuss the control variables briefly for general interest. Table A5 in the appendix reveals that firm investment is more likely when home and host countries share a common language or common colonial history, when home and host countries are geographically close, and when home and host countries have a bilateral investment treaty.[30] At the firm level, firms already operating in more host countries are significantly more likely to open new foreign subsidiaries. Among host-country factors, host's economy size (measured by logged GDP) is the only statistically significant predictor of subsidiary incorporation once we control for other factors.

Table 2's main findings are robust to alternate model specifications and estimation strategies. Our results are substantively similar if we loosen assumptions about the interaction's linearity and

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[28]The small scale of the predicted probabilities is common with dyadic analyses of infrequent events. New subsidiary incorporations are dwarfed by the number of potential hosts not chosen, making the probability of foreign subsidiary incorporation very low. In a context where hundreds of thousands of observations have zero investment, changes of 0.01 or 0.02 in the predicted probability of incorporation are actually substantial.

[29]The difference in the marginal effects at low versus high values of home judicial independence is statistically significant at $p < 0.001$.

[30]This relationship appears to operate separately from the dynamics we are studying – whether or not we control for BITs does not meaningfully change our main coefficients of interest. Moreover, although the variables have the same 0-1 scale, the BITs coefficient estimates are many times smaller than the interaction term's (for example, in column 2: $\beta_{BITs} = 0.194$ vs. $\beta_{homeXhost} = 2.138$).

replace the continuous home LJI measure with a series of categorical dummies. Likewise, we obtain consistent results if we replace our interaction term with an alternate operationalization using the absolute distance between home/host LJI scores (yielding a negatively-signed and significant coefficient). Results are similarly robust to including home-host interactions for the other institutional variables (political constraints and democracy), controlling for hosts' natural resources using fuel exports, controlling for the prevalence of North-North investment dyads, or using multiple imputation to handle any missing data. We also control for home countries' uncertainty aversion profiles from Hofstede (2001) to investigate whether results reflect investors' different risk tolerances; we find no meaningful changes. Addressing the preponderance of OECD firms in the data, we find similar results if we drop OECD host countries altogether. More drastically, dropping *all* OECD countries (host and home) removes roughly 90% of sample, yet the findings persist. Similarly, results do not depend on having China in the sample as host or home country. Results for these additional analyses and robustness tests appear in the online appendix.

Using data on the incorporation of foreign subsidiaries as a comparable instance of MNE foreign direct investment, we have shown at the firm level that the attractiveness of host country institutions to investors depends upon the kind of institutions that firms have dealt with at home. These findings have substantial implications for prominent research agendas in international and comparative political economy. At a minimum, they suggest that unless researchers consider the conditioning effects of investors' home environment, extant arguments cannot fully explain how institutions attract or deter FDI. In the next section, we leave aside the firm subsidiaries data to investigate whether similar patterns exist in cross-national, aggregate data on bilateral FDI.

II. Outward FDI Position Data

Our second dataset comes from the Coordinated Direct Investment Survey (CDIS), an IMF project initiated in 2009 to improve the comparability and coverage of cross-national data on FDI distribution and volume.[31] Surveyed firms in participating countries report on foreign equity ownership in their enterprise and their own equity holdings of enterprises in foreign countries. The IMF uses

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[31]For detailed information on the survey see: `https://www.imf.org/external/np/sta/cdis/index.htm`.

these nationally-representative samples to estimate countries' overall inward and outward FDI positions. Here, we focus on countries' estimated outward FDI positions, which represent the value of their firms' investments in companies abroad. Disaggregated by partner country, the resulting dataset is of outward FDI stocks within directed home-host country dyads.

These IMF data have several advantages. First, compared to typical cross-national datasets, the CDIS's methodology appears to yield high-quality, comparable statistics on FDI stock. Moreover, the CDIS data cover outward FDI from the developing world far better than any other available dataset. Our models using these data include information from at least 154 home countries and 147 host countries. Thus, these data provide a welcome counterbalance to the developed-country skew of our Orbis data. However, the CDIS project's newness means that only three years of data were publicly available when we built our dataset. Since FDI stocks typically vary little from year to year within a short timespan, we average the data for this period and treat the data as cross-sectional.

The dependent variable for our analyses of the CDIS data is home country i's average total outward FDI position in millions constant USD (logged) in host country j during the period 2009-2011. Our independent variables of interest remain home LJI, host LJI, and their interaction. We reuse all the country-level and home-host dyad control variables from the previous analysis to account for alternative explanations and establish consistency across our analyses. To guard against bias and account for the temporal lag in investors' decision-making, all right-hand-side variables are measured in 2008, the year before the first CDIS survey. Methodologically, we continue with the multilevel approach to model home countries' average total outward FDI position in their dyadic partner as a function of the interaction of the countries' judicial institutions, theoretically-relevant control variables, and unobserved home-, host-, and dyadic-specific factors that enter the model via random intercepts. Once more, we only display estimates for our main variables of interest with full results presented in the appendix (Table A9).

Table 3 reveals consistent statistical support for our main argument.[32] As seen earlier, the interaction between home and host judicial institutions is positive and statistically significant across all models. Substantively, this indicates that the ability of host countries' judicial institutions to

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[32]Although the table focuses on the main variables of interest, control variables' coefficient estimates appear in full in the appendix.

attract FDI depends on investors' home judicial environment. The higher the home LJI score, the more positive the association between FDI and host countries' judicial independence. The marginal effects plot in Figure 3 demonstrates this conditional relationship.

We have argued that firms from countries with low judicial independence develop capabilities well-suited to operating in other environments where courts are weak and ineffective. Figure 3's left side indicates that, all else equal, investors from lower-LJI countries invest less in higher-LJI hosts, where autonomous and effective courts necessitate legal capabilities that they might not have developed. Whereas the firm-level results indicated that these MNEs had less enthusiasm for independent host courts, the aggregate FDI data suggest that such firms may actually reduce their investment in the presence of strong judicial institutions.[33] We have also argued that investors from countries with highly independent courts develop skills and strategies that enable them to successfully protect their interests by engaging legal institutions; as such, they are more likely to be attracted to host countries with greater judicial independence. This is reflected on Figure 3's right side. The plot indicates that, all else equal, economic actors from high-LJI environments send more FDI to high-LJI host countries.

We conduct multiple robustness tests on these models. The results do not change substantively if, instead of averaging the data, we use the annual position data year-by-year or pooled together. Results are also robust to analyzing only non-OECD hosts, restricting the sample exclusively to non-OECD countries, excluding China, or controlling for uncertainty aversion. Finally, because many directed dyads report a value of zero investment, one might wonder if non-investment dyads belie an unmodeled selection process that biases our results. Accordingly, we conduct a two-stage analysis in which the first stage models the probability that a directed dyad will have *any* FDI; in the second-stage, we then model outward FDI stock within directed dyads, conditional on the predicted probability of non-zero investment. This additional test does not change our findings in

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[33]While content to let the data to speak for themselves, we offer some thoughts on the datasets' disagreement on this point. One possibility is that the difference in dependent variables – firm location choice versus aggregate investment amounts – reveals a theoretical nuance: these MNEs are not averse to entering countries with "good" institutions, but their relative disadvantages in operating there lead them to invest less compared to what they would under different institutional conditions. Quite likely, the differences originate in the samples' data coverage. Because the IMF data include roughly 100 more home countries and 50 more host countries than the Orbis data (all of them non-OECD countries), the IMF data may simply provide a more complete picture of how investment from all parts of the distribution respond to different host institutions.

Table 3: **IMF's Cross-Sectional Bilateral FDI Data: Total Outward FDI Position (avg. 2009-2011)**

DV: Outward FDI Positions *in millions constant USD (logged)*	(1)	(2)	(3)	(4)
Judicial Independence *LJI latent scale (0-1), mean-centered*				
Home × Host	14.011*** (0.663)	13.232*** (0.649)	13.148*** (0.722)	9.817*** (0.688)
Home	9.492*** (1.278)	3.450*** (1.288)	3.333*** (1.282)	3.778*** (0.765)
Host	5.154*** (1.255)	0.517 (1.198)	0.506 (1.172)	0.886 (1.176)
Political Constraints (Host) *POLCON scores, ranging 0 to 1*		−0.755 (1.345)	−0.640 (1.315)	−0.897 (1.320)
Democracy (Host) *dummy, 1 = dem.*		1.235** (0.576)	1.163** (0.563)	1.229** (0.565)
GDP per capita: (Home × Host) *constituent terms also in model*				0.297*** (0.025)
GDP, logged: (Home × Host) *constituent terms also in model*				0.194*** (0.014)
Number of Observations	11,234	9,995	9,995	9,995
Number of Host Countries	166	147	147	147
Number of Home Countries	166	154	154	154
All Control Variables	No	Yes	Yes	Yes
Home-Host Dyad Intercepts	No	No	Yes	No

Note: Selected coefficient estimates from multilevel linear regressions modeling average total outward FDI position from one country in a given host country. All models include random intercepts for home and host countries. In addition to those variables listed in the table, Models (2) through (4) also include controls for dyadic trade between countries, home GDP per capita, bilateral investment treaties, size of host economy, total FDI inflows to host, home economic growth, common language, and shared colonial history. Model (4) includes the interactions of home/host GDP per capita and economy size, as well as their relative constituent terms. To save space, coefficient estimates for control variables presented in the supplementary appendix. Standard errors in parentheses; *** indicates $p \leq .01$, ** indicates $p \leq .05$.

Figure 3: Marginal Effects of Judicial Host Institutions on Bilateral FDI Stocks
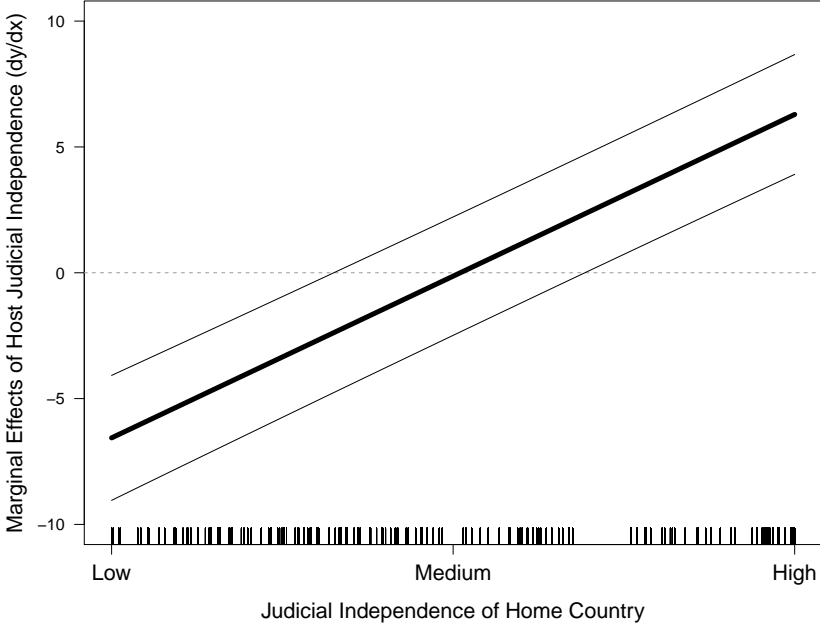
Note: Plot generated using coefficient estimates from column 2 in Table 3. Bands represent 95% confidence intervals.

any notable way. Results for the additional analyses appear in the appendix.

Overall, these analyses using data on countries' outward FDI positions support the previous firm-level results: whether countries' institutions attract or deter investment depends in part upon investors' institutional environment at home. Countries with higher levels of judicial independence attract more FDI from countries that also have independent judiciaries. Additionally, the results also indicate that outward FDI from countries with low judicial independence is negatively correlated with independent host courts. Provocatively, this suggests that autonomous judicial institutions may actually discourage investment from investors who deal with weak and ineffective courts at home. Having now identified these patterns in bilateral FDI stock data and firm-level subsidiary data, the next section investigates the empirical support for our hypotheses in longitudinal data on bilateral FDI flows.

III. Longitudinal Bilateral FDI Flows Data

As a final robustness test of our main findings, we analyze data collected by the United Nations Conference on Trade and Development (UNCTAD) on bilateral FDI flows. In contrast to our previous datasets, these data allow us to study the interaction of home and host institutions using several decades of FDI data (1981-2006). The dataset's main drawback, however, is limited coverage; UNCTAD provides bilateral FDI data for roughly 15% of dyad years between 1981 and 2006. Missing data notwithstanding, UNCTAD currently provides the most extensive data available on bilateral FDI flows over time.[34] With this caveat, we construct a time-series cross-sectional dataset using the UNCTAD data, taking the directed dyad-year as the unit of analysis. The baseline sample includes 2127 directed dyads, with 47 unique home countries and 163 host countries.

The dependent variable is net outward direct investment flows within directed dyads from home i to host j, reported in (logged) millions constant USD. We divide the data into discrete three-year periods and use averaged values for each period in order to smooth out noisy annual fluctuations from "lumpy" investments. As above, we focus on the LJI measures and their home/host interac-

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[34]As with the previous two analyses, using multiple imputation provides similar findings to our main results below. However, given the substantial coverage issues, we caution against generalizing from these data in isolation and consider these results only as a longitudinal supplement to our previous findings.

tions as our main independent variables, and we include the same set of control variables employed in the previous analyses. All time-varying covariates are lagged by one time period to account for some temporal delay in investment decision-making.

As before, we model bilateral FDI flows using multilevel regression with various combinations of home, host, and dyad intercepts to account for repeated observations within groups and help capture unmodeled group-level heterogeneity.[35] All models include varying intercepts for time period to account for common shocks within a given time period. Table 4 reports the results for our main variables of interest (full results presented in appendix Table A14).

Looking at Table 4, we observe results that are consistent with both the firm-level subsidiary data and the cross-sectional FDI positions data. These longitudinal data on FDI flows agree that the relationship between host institutions and foreign investment depends upon investors' home institutional environment. The coefficient estimates on the LJI interaction term remains positive and statistically significant. This indicates that, at higher values of home LJI, increases in host LJI correspond to increasingly greater FDI flows. This is true in models without control variables (1), adjusting for all controls (2) and even controlling for the interactions between home/host economic conditions (4). In column 3's model, we include a lagged dependent variable to account for potential serial autocorrelation and control for unobserved factors that may have shaped past dyadic FDI flows. This lagged dependent variable soaks up much variation in the model and reduces the sample size, yet the LJI interaction's coefficient estimate remains positive and statistically significant. Finally, the last two columns confirm the findings's robustness if we control for unobserved dyad effects or use annual data instead of three-year averages.[36]

Using these estimates, the marginal effects plot in Figure 4 tells a familiar story. On average, an increase in hosts' judicial independence is associated with more FDI inflows from countries with highly-independent judiciaries and less FDI inflows from countries with less independent courts.

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[35]The fixed effects estimator, while often a sensible choice for time-series cross-sectional analyses, focuses solely on within-unit variation. Given the slow-moving or time-invariant nature of political institutions within directed dyads, our data are a poor fit for fixed effects estimation.

[36]Results in Table 4 are robust to the same alternative specifications described in previous sections. Furthermore, results are effectively unchanged if we analyze each time period separately, average over five-year time periods, or use a two-stage process to control for the predicted probability that a host receives non-zero FDI from a given home country. See appendix for associated results.

Table 4: **UNCTAD Bilateral Data, Net FDI Outflows (1981-2006)**

DV: NET FDI OUTFLOWS *in millions constant USD (logged)*	(1)	(2)	(3)	(4)	(5)	(6)
JUDICIAL INDEPENDENCE *LJI latent scale (0-1), mean-centered*						
HOME × HOST	6.350***	5.098***	1.976***	2.468***	4.750***	4.759***
	(0.300)	(0.308)	(0.332)	(0.325)	(0.408)	(0.243)
HOME	1.020**	0.863**	0.394	1.062***	0.705	1.431***
	(0.438)	(0.439)	(0.357)	(0.385)	(0.368)	(0.394)
HOST	0.753***	−0.346	−0.383**	0.186	−0.469**	−0.062
	(0.230)	(0.255)	(0.176)	(0.250)	(0.235)	(0.229)
POLITICAL CONSTRAINTS (HOST) *POLCON scores, ranging 0 to 1*		0.030	0.102	0.043	−0.062	−0.039
		(0.194)	(0.158)	(0.185)	(0.156)	(0.131)
DEMOCRACY (HOST) *dummy, 1 = dem.*		0.049	0.083	0.009	0.022	−0.103
		(0.108)	(0.079)	(0.104)	(0.091)	(0.083)
FDI OUTFLOWS$_{t-1}$ *lagged DV*			0.645***			
			(0.011)			
GDP PER CAPITA: (HOME × HOST) *constituent terms also in model*				0.196***		
				(0.015)		
GDP, LOGGED: (HOME × HOST) *constituent terms also in model*				0.138***		
				(0.006)		
Number of Observations	7,850	6,913	4,927	6,913	6,913	13,597
Number of Host Countries	163	140	137	140	140	140
Number of Home Countries	47	47	44	47	47	47
Time Periods	3-yr avg	3-yr avg	3-yr avg	3-yr avg	3-yr avg	annual
Number of Time Periods	9	9	9	9	9	26
All Control Variables	No	Yes	Yes	Yes	Yes	Yes
Home-Host Dyad Intercepts	No	No	No	No	Yes	No

Note: Selected coefficient estimates from multilevel linear regressions modeling net outward FDI flows into a given host country. All models include random intercepts for home and host countries and time period. In addition to those variables listed in the table, Models (3) through (6) also include controls for dyadic trade between countries, home GDP per capita, bilateral investment treaties, size of host economy, total FDI inflows to host, home economic growth, common language, and shared colonial history. To save space, coefficient estimates for control variables presented in the supplementary appendix. Standard errors in parentheses; *** indicates $p \leq .01$, ** indicates $p \leq .05$.

Figure 4: Marginal Effects of Host Judicial Independence – UNCTAD Data
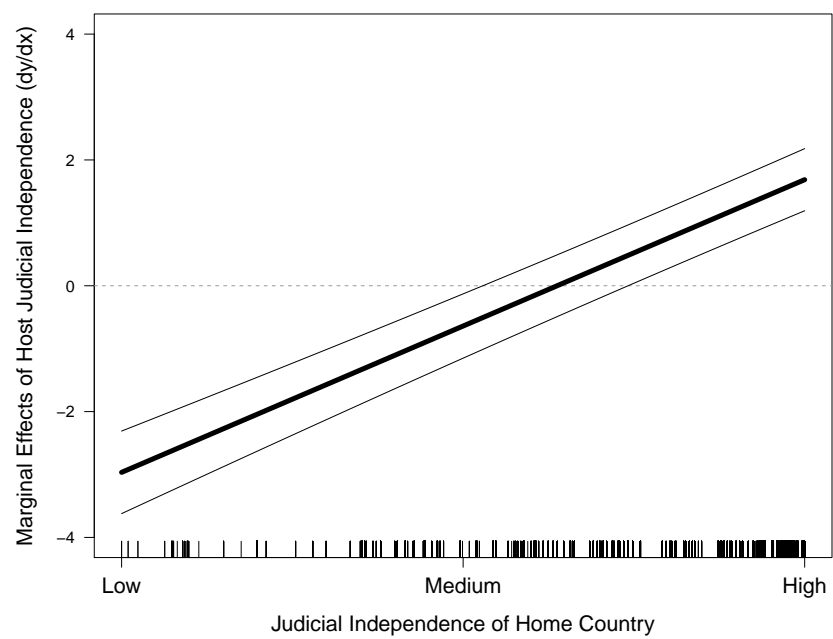
Note: Plot generated using coefficient estimates from column 2 in Table 4. Bands represent 95% confidence intervals.

Consistent with our argument, improved judicial independence in host countries appears to be most attractive to investment from home countries with highly independent judiciaries and least attractive to investment from countries where judicial institutions display low independence.

In this and the previous sections, we have tested our theory's main empirical predictions about the interactive effects of home and host institutions on FDI by triangulating across three independent and extensive pools of data: multinational firms' incorporation of foreign subsidiaries, countries' outward FDI positions, and bilateral FDI outflows. That the same results appear repeatedly across these separate analyses increases confidence in our findings. Taken together, the analyses suggest a striking implication: however desirable from the standpoint of prevailing theories, robust and independent judicial institutions are not uniformly attractive to investors in practice. The effects of host institutions on FDI appear to depend in part upon where investors are coming from.

Conclusion

This paper provides one answer for why countries with traditionally "unattractive" institutions can still receive FDI: home institutions influence firms' preparedness to deal with host institutions abroad. Therefore, the challenges of imperfect home institutions can prepare some economic actors to operate successfully in countries where institutional conditions are considered too risky for their competitors from more orderly institutional environments. Just as our research suggests that "bad" institutions may not deter all types of investors, it also implies that "good" institutions are not equally optimal for all multinational firms. This argument provides a fresh perspective on the relationship between institutions and FDI and has several implications for the literature.

First, our theory and its empirical support suggest that the perceived benefits and drawbacks of host institutions depend in part upon where international investors come from. Across multiple datasets at different levels of analysis, we show that independent judicial institutions are not uniformly attractive to FDI. Independent host courts appear to be particularly attractive to investors who have independent courts at home. Similarly, FDI from countries lacking independent courts goes disproportionately to host countries also lacking independent courts. These robust find-

ings strongly suggest that, by ignoring heterogeneity among investing firms and their institutional background, much of the existing political science research on FDI could be masking similar results.

Likewise, this paper's emphasis on MNEs' home institutions reminds scholars that FDI originates from somewhere, and that origin is not always among the developed world's advanced democracies. The growth of FDI from the developing world is changing global investment's composition. Our theoretical framework is the first in the discipline of which we are aware that reflects this by considering explicitly: 1.) that the home experiences of firms from many developing countries contrast starkly with those of their developed- world counterparts, and 2.) that such differences shape how firms from each type of location perceive the political risks associated with a given host institution. We hope that further research uncovers additional implications from the increasing variation within the set of global investors.

Within political science, there is a sizable literature concerning whether or not globally-mobile capital encourages institutional convergence because of pressures to reform (e.g. Mosley 2003, Quinn 1997, Wilson & Wildasin 2004). One interpretation of our results is that countries with "unattractive" institutions may face less pressure for institutional reform than previously acknowledged. If outward FDI continues to grow from China, Russia and similar emerging markets, the pressures encouraging political institutional convergence may be undermined by MNEs that are prepared to deal with countries' messy institutional environments as they exist today.

Although we have only had space to focus on one type of institution in our discussion, we believe the argument's logic generalizes beyond judicial independence. Further research can build upon these results by theorizing when skills and strategies developed at home transport across institutional contexts and when they do not. Furthermore, as a first cut at the problem, we have considered FDI very broadly in our theory and empirics. There may, however, be important differences to discover using our framework with firms' mode of entry or preferred type of investment, such as greenfield versus brownfield investment projects.

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