Institutions & Perceptions of Political Risk in International Investment

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FDI & Institutions: Addressing Enduring Concerns

Domestic political institutions $\rightarrow$ *political risk* $\rightarrow$ investment outcomes

FDI & Institutions: Addressing Enduring Concerns

Domestic political institutions $\rightarrow$ *political risk* $\rightarrow$ investment outcomes

Enduring concerns:

- Correlated institutions $\rightarrow$ hard to establish causal relationships
- Mismatch between theoretical mechanisms & empirical level of analysis

Survey Experiment on Investors' Perceptions

Disaggregate effects of covarying institutions

- Which matters more: stable policy environment or strong courts?

Exploring heterogeneity across investors

- Do investors' home institutions affect the way they perceive host-country risk?

Is Political Risk Relative?

A theoretical question motivated by an empirical trend

Table: **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

“Trading up” hypothesis:

- High-risk background $\rightarrow$ greater preference for ‘safe’ institutions

How do Home Institutions Shape Perceptions of Risk?

Competing Predictions

"Trading up" hypothesis:

- High-risk background → greater preference for 'safe' institutions

"Competitive advantage" hypothesis:

- High-risk background → less deterred by 'risky' institutions

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"Competitive advantage" hypothesis:

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"Heterogeneous risks" hypothesis

- Relative risk comparisons may be conditional on institution.
- Some skills for mitigating risks may transport better than others.

Whom to survey? International MBAs

We conduct survey experiments using managers-in-training at prestigious international school business.

Recruitment:

- Subjects recruited from MBA program at IE Business School (ranked #1 in Europe).
- Conducted online as a "consulting" exercise for required course.

Administration:

- Experiments administered online via Qualtrics.
- 170+ subjects since Fall 2013.

Whom to survey? International MBAs

Students come from a wide variety of home countries.

- Albania, Argentina, Australia, Austria, Azerbaijan, Belgium, Brazil, Canada, China, Colombia, Costa Rica, Denmark, Egypt, France, Georgia, Germany, Honduras, Hungary, India, Ireland, Italy, Japan, Jordan, Kazakhstan, Korea, Kuwait, Lebanon, Luxembourg, Mexico, Netherlands, New Zealand, Nigeria, Pakistan, Peru, Philippines, Portugal, Romania, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Ukraine, UK, US, Venezuela

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Survey: Impact of institutions on two decisions

1. Whether or not to invest
2. How much to invest given varying rates of return

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Invest or not to invest

Imagine that QSQ Global is considering investing in a developing country that has a population of 18 million people and is considered politically stable. GDP grew by 4.5% last year, a little more than the average rate in its region. According to observers, the country's court system **[helps businesses / can make it difficult for businesses to]** protect their interests and resolve legal disputes quickly...

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Invest or not to invest

...The country's current tax rates and regulatory standards for your client's industry are similar to those in competitor countries. These policies **[have not changed much in the recent past / have changed much in the recent past; some changes have increased businesses' costs while others have reduced them]**. Experts believe that the country's political system makes it **[unlikely / likely]** that there will be policy changes in the near future.

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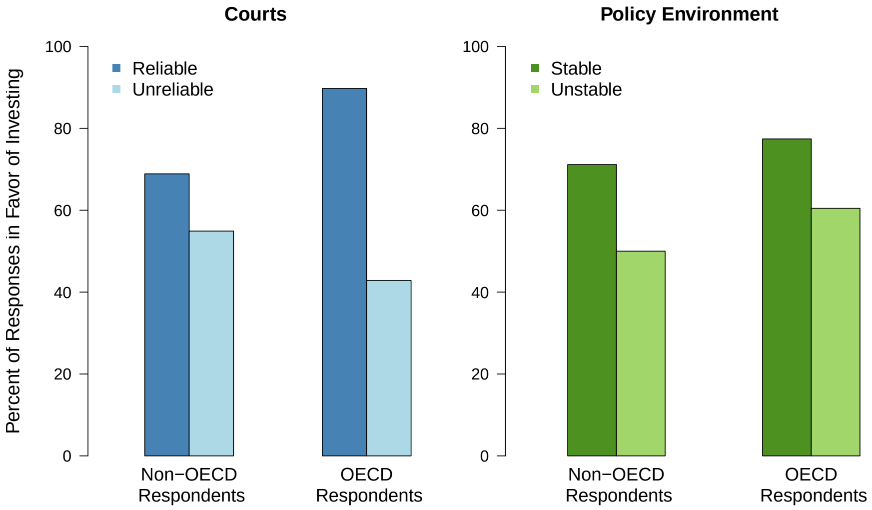
Invest or not to invest: Empirical Results

Table: **Differential Effects of Institutions on Willingness to Invest**

Treatment	No	Yes	Difference
Do country's **courts** help businesses protect their interests?	50% (n=86)	78.6% (n=84)	28.6 (p=0.001)
Is the **policy environment** stable?	55.2% (n=87)	73.5% (n=83)	18.3 (p=0.001)

Results: Conditional on Home Country



Survey: Impact of institutions on two decisions

1. Whether or not to invest
2. How much to invest given varying rates of return

How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A

- Courts can be relied upon to resolve legal disputes impartially and enforce firms' property rights effectively.

Country B

- Courts cannot be relied upon to resolve legal disputes impartially and enforce firms' property rights effectively.

How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A	Country B
Some firms have maintained/expanded their operations because of courts.	Some firms have reduced their operations because of courts.

How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A

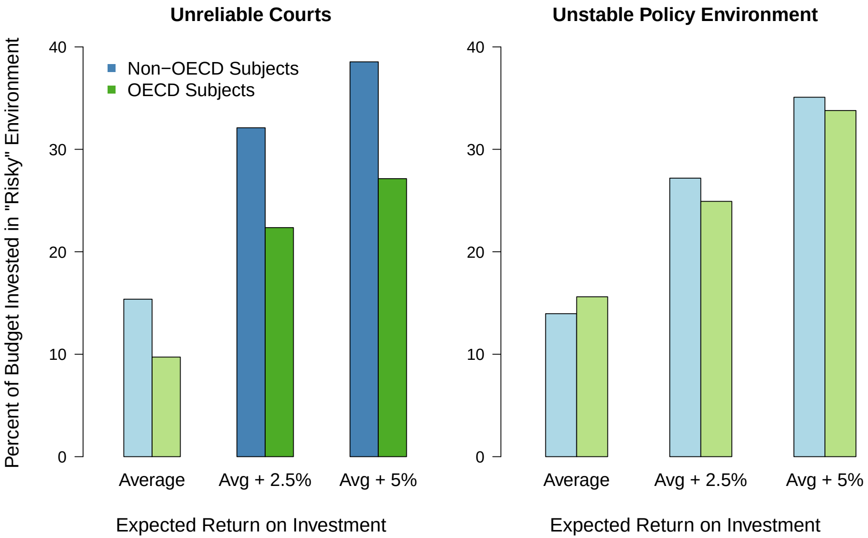
- Returns on investment are nearly **identical to** your industry's global average.

Country B

- Returns on investment are nearly **[identical to / 2.5 percentage points higher than / 5 percentage points higher than]** your industry's global average.

OECD Respondents Most Sensitive to Courts

Sensitivity to Institutional Risks at Varying Rates of Return



Conclusion: Perceptions of Risk are Relative

- Perceptions of institutions and their capacity to shape political risk can vary across individuals depending on:
  - Where they are from (home institution quality)
  - Type of institution
- Our evidence suggests that courts and their ability to protect property rights has a more potent impact than policy stability on respondents' investment decisions
- OECD respondents are more sensitive to the judicial environment than non-OECD respondents

Thank you in advance for comments and suggestions.

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International MBAs

Expected demographics of respondent sample:

- Male (77%)
- 29+ years old (>50%)
- Business education background (45%)
- Many have experience in big firms: HSBC, Bayer, JP Morgan, Hitachi

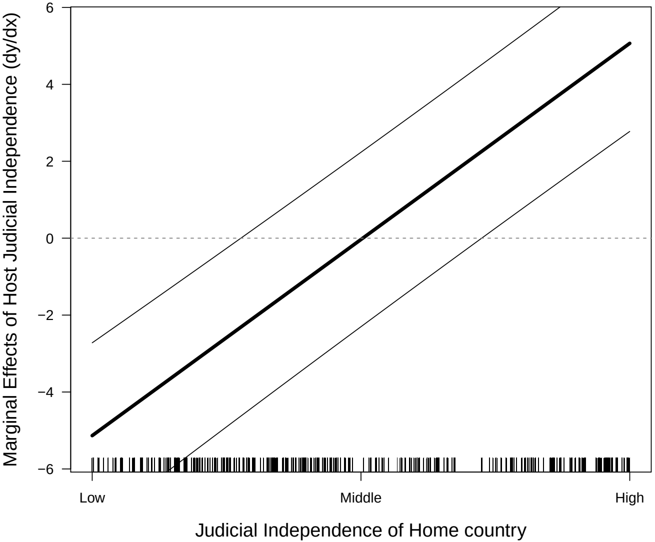
Dependent Variable

Based on the description of this country, what would you recommend to your client?

1. Explore investment opportunities in this country
2. Find an alternative location for investment

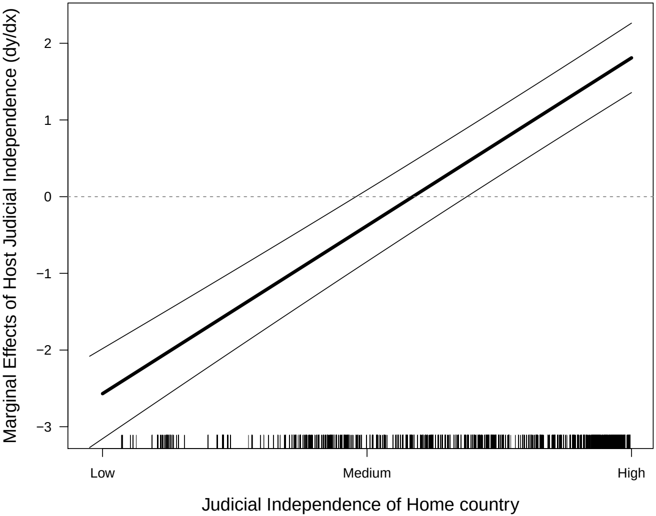
Evidence from Observational Data

Bilateral FDI data from the IMF



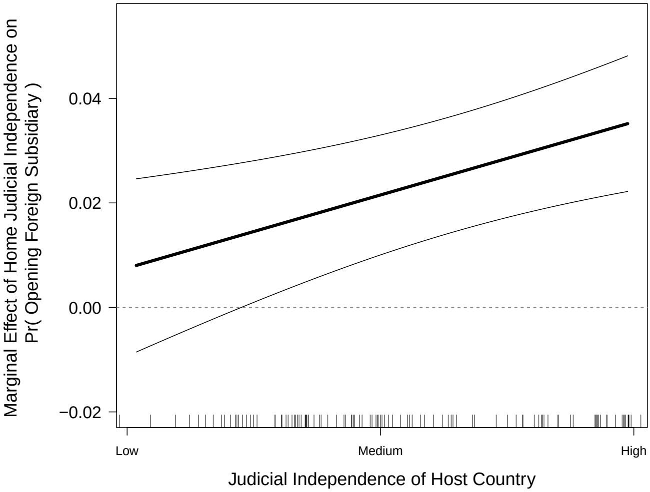
Evidence from Observational Data

Bilateral FDI data from UNCTAD



Evidence from Observational Data

Bilateral FDI data from Orbis



How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A

- Current tax policies and regulations are investor-friendly, and they have remained constant over the recent past.

Country B

- Current tax policies and regulations are investor-friendly, but they have changed several times in the recent past.

How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A

- The stability of economic policies is an important reason that some firms have maintained or expanded their operations in the country.

Country B

- The instability of economic policies is an important reason that some firms have scaled back their operations in the country.

How to Much to Invest in Risky Location?

Within subject response to varying returns on investment

Country A

- Firms that do survive and succeed in this environment earn returns on investment that are nearly identical to your industry's global average.

Country B

- Firms that do survive and succeed in this environment earn returns on investment that are nearly **[identical to / 2.5 percentage points higher than / 5 percentage points higher than]** your industry's global average.

Respondents from Developed Countries More Sensitive to Institutional Risks

DV: % Allocated to "Risky" Country

	ROI in "Risky" Country		
	Avg.	Avg. + 2.5%	Avg. + 5%
CONSTANT	15.5	28.8	37.3
	(2.4)	(2.3)	(2.4)
DEVELOPED HOME COUNTRY	-2.0	**-6.0**	**-6.2**
dummy; 1 = OECD home country	(2.9)	**(2.8)**	**(2.9)**
INSTITUTIONAL SCENARIO	-1.8	1.7	-0.9
dummy; 1 = courts version	(2.9)	(2.8)	(2.9)
Number of Observations	170	170	170