Political Risk is Relative:
How Home Institutions Shape Investment Abroad

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Domestic political institutions → political risk → investment outcomes

Institutions reduce political risk by:

- constraining opportunistic behavior
- making property rights more secure
- reducing policy uncertainty
**Status quo:** “Good” institutions attract FDI & “bad” institutions deter FDI
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**Our claim:** Whether institutions attract or deter FDI depends on investors’ institutional environment at home.
How do home institutions influence host institutions’ ability to attract FDI?
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Home institutions affect how firms act to protect their business interests.
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Home institutions affect how firms act to protect their business interests.

These practices influence where firms are better prepared to operate abroad.

- Depending on host institutions, these pre-existing practices can be an advantage or disadvantage.
Empirical Predictions
Applied to judicial independence (JI)

High JI home → more likely to invest in host with high JI

Low JI home → more likely to invest in host with low JI
Firm-level Data: Creation of Firms’ Foreign Subsidiaries (2007-2011)

<table>
<thead>
<tr>
<th>DV: New Foreign Subsidiary dummy; 1 = subsidiary established</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judicial Independence</td>
<td></td>
<td></td>
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<tr>
<td>LJI latent scale, ranging 0 to 1</td>
<td></td>
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</tr>
</tbody>
</table>

|                         |          |          |
| Home × Host             | 1.917*** | 2.157*** |
|                         | (0.307)  | (0.404)  |

| Home                    | –1.369***| –1.801***|
|                         | (0.273)  | (0.357)  |

| Host                    | 3.362*** | 1.768*   |
|                         | (0.463)  | (1.040)  |

Number of Observations 398,508 345,709
Number of Host Countries 103 99
Number of Home Countries 62 56
All Control Variables No Yes
Sector Intercepts No Yes
IMF Data: Bilateral Outward FDI Positions (2009-2011)
Marginal Effects of Host Institutions, Conditional on Home Institutions

![Graph showing the marginal effects of host judicial independence on FDI positions.](image)

- **Judicial Independence of Home Country**
- **Marginal Effects of Host Judicial Independence (dy/dx)**
  - Low
  - Medium
  - High
Marginal Effects of Host Institutions, Conditional on Home Institutions

Judicial Independence of Home Country

Marginal Effects of Host Judicial Independence (dy/dx)

Low
Medium
High

Risk is Relative

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Firm Survey Data: Testing the Mechanism
Do firm strategies vary systematically across institutional environments?

Composition of Firms' Sales, by Time of Payment

Percent of Annual Sales

Judicial Independence

Composition of Firms' Sales, by Time of Payment

Paid
After Delivery

Paid At Delivery

Paid
Before Delivery

Low
Medium
High

Judicial Independence

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Conclusion: Political Risk is Relative

- “Good” institutions are not uniformly attractive to FDI.

- Not all investing firms come from the OECD.

- Variation in investing firms’ background influences attractiveness of host environment.

- Countries with “bad” institutions still attract FDI because some investors already have the tools for dealing with unreliable institutions.
Thank you in advance for comments and suggestions.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Billions of USD</th>
<th>% of World Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>0.05</td>
<td>0.36</td>
</tr>
<tr>
<td>1980</td>
<td>3.19</td>
<td>6.19</td>
</tr>
<tr>
<td>1990</td>
<td>11.91</td>
<td>4.93</td>
</tr>
<tr>
<td>2000</td>
<td>137.39</td>
<td>11.15</td>
</tr>
<tr>
<td>2010</td>
<td>388.15</td>
<td>29.33</td>
</tr>
</tbody>
</table>
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Amount of Bribes Paid to 'Get Things Done'

Judicial Independence

Percent of Annual Sales

Low Medium High

Risk is Relative

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