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Governance and Foreign Direct Investment

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Economic governance

Institutions, organizations for property right protection & contract enforcement

Essential for functioning of economic activity:

capital accumulation, production specialization, goods & services exchange

Institutions of governance:

- The state's legislative and judicial system
- Social networks for communication, norms, sanctions

Quality and mix of institutions varies widely across countries

Governance is always less than perfect

Formal governance is quite bad in many LDCs and transition economies

Government and its agents may themselves violate rights, contracts

Foreign firms' rights are especially at risk

This raises special problems for trade, and even more for FDI

A rough but useful measure of governance quality

World Bank Indexes: rank each of 212 countries by percentile (0–100)

Average 2008–10 of Regulatory Quality, Rule of Law, and Corruption:

Country	Rating	Country	Rating
Somalia	0.05	Egypt	44.75
Afghanistan	1.65	India	45.98
Venezuela	5.34	Mexico	46.53
Nigeria	17.86	Brazil	54.53
Pakistan	22.85	South Africa	60.93
Russia	24.49	Italy	66.42
Kenya	26.44	Israel	78.40
Argentina	31.41	United States	90.15
Indonesia	34.10	Australia	95.96
China	43.24	Denmark	99.47

Countries with weak governance do attract FDI

UNCTAD's Inward FDI data

http://unctadstat.unctad.org/TableViewer/tableView.aspx?ReportId=88

Annual averages for	World Total $ million	Developing Countries $ million	Developing Countries % of world	Transition Economies $ million	Transition Economies % of world
1986-1990	158,354	26,714	16.9	18	0.01
1991-1995	228,332	77,766	34.1	2,233	0.98
1996-2000	814,961	202,906	24.9	7,989	0.98
2001-2005	750,164	239,904	32.0	20,471	2.73
2006-2010	1,521,120	548,928	36.1	81,282	5.34

How FDI can proceed despite poor governance

Firms and countries have *ex ante* incentives to develop devices
and institutions that can substitute for poor overall governance

- Choose transaction form appropriate for context
  Weak contract enforcement? Use vertical integration (internal governance),
  wholly owned subsidiary instead of joint venture with local firm
- Use intermediary having long term relationship with both parties
  Historic examples: Rothschilds, Morgans. More recently Hong Kong
- Home country's credible commitment not to expropriate
  Using external assets as collateral (hostage)
- Bilateral investment treaties between countries
  Direct effectiveness limited, but useful signal of country's investor-friendliness
  May create rat-race; give investors excessive rights against normal policy changes
  But may create 'halo effect' that improves governance for domestic firms also

Usual assumptions in theories of FDI

- MNC is Northern firm
- Has advantage in R&D, high-tech, management
- Information makes these non-contractible
- Southern host country has cost advantage in low-tech production,
  this may also be non-contractible
- Internal governance (vertical integration) can reduce risks
  to contract, property; so may reduce overall costs
- MNC chooses its mode of operation to be optimal
  constrained by information and contractibility
- Williamsonian transaction cost economics in international setting
  Developed independently by Dunning, Hymer, Caves etc.
  Recent work by Markusen, Grossman-Helpman, Nunn etc.

Contrast with recent FDI in the news

Many and very successful MNCs are from "southern" countries

("Southern" is catch-all for "third world" and "transitional" economies)

- Lenovo buys IBMs PC division
- Mittal invests in Indonesia, E. Europe; buys Arcelor
- Tata buys Jaguar, Land Rover; Geely buys Volvo
- Chinese, Indian, Malasian oil companies in Africa
- Brazilian Petrobras and Vale operate in many countries

Questions

How important are these examples?

What theories or models can explain them?

Magnitude of FDI from southern countries

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Annual averages for	World Total $ million	Developing Countries $ million	Developing Countries % of world	Transition Economies $ million	Transition Economies % of world
1986-1990	179,365	11,111	6.19	0	0.00
1991-1995	258,573	35,742	13.8	710	0.27
1996-2000	776,262	77,624	10.0	2,254	0.29
2001-2005	735,174	84,361	11.5	9,328	1.26
2006-2010	1,596,913	285,613	17.9	49,015	3.07

Some other facts concerning southern MNCs

From World Investment Review 2006, UNCTAD and other sources

Magnitudes

In 2005 Southern MNCs FDI outflows were \$133 billion,

$=$ 17% of the world total FDI flow of \$779 billion

Stock of southern MNCs' FDI $=$ \$1.4 trillion, 13% of world total

Outflows of FDI from Asian Arc (S, SE and E Asia) $=$ \$68 billion

From Eastern Europe \$15 bn, of which 87% from Russia

South-South FDI flows rose from \$2 bn in 1985 to \$60 bn in 2004

Number of southern MNCS 20,000; this is 26% of total,

$26 > 13$ or 17, so southern MNCs are smaller than average

Concentration

Table shows % of stock in 2004; rows don't sum to 100 b/c "unspecified other"

		From (Source, Home)	
		DCs	LDCs
In (Host)	DCs	92.8	6.1
	Asian Arc	32.9	64.8

So southern MNCs invest mainly in other southern countries

Also intra-region concentration – in Asia, Latin America, E. Europe / Russia

Overall inference

Substantial, growing phenomenon with special features, merits attention

Early literature

Theodore Wells, *Third World Multinationals,* 1983

Sanjaya Lall et al., *The New Multinationals,* 1983

Some key findings

- Southern MNEs smaller
- Technologies, management are adapted to local conditions
- Developed skills to manage low-skilled workers
- More likely to engage in joint ventures
- More likely to engage in bribery of local officials
- Sectoral composition gradually broadening

Usual explanations (not mutually exclusive)

- Poor home-country governance makes FDI more attractive
  (was especially relevant for India in the 1970s and 80s)
- Responding to approach by host country firm or government
  sometimes b/c preference for a southern MNC
- Southern firms use FDI to acquire modern technology
  More relevant for southern FDI into advanced countries
- To acquire natural resources or land rights
  (esp. relevant for recent Chinese investments in Africa etc.)
- Their home governments encourage or subsidize the FDI
  b/c national policy to acquire technology, resources etc.

Additional new hypothesis, related to governance

Poor host-country governance creates non-contractibility

This reason is additional to usual one of non-verifiability of relevant info

Southern MNEs better at coping with bad governance

Reasons for Southern MNCs governance advantage

- Technology better adapted for poor governance
- Know importance of contacts and relationships to navigate regulatory obstacles; have experience in doing so
- More used to bribery; less constrained by home country laws, NGOs
- Pre-existing ethnic and linguistic networks

Some evidence in support of hypothesis

Case Studies, Anecdotal

- Chinese ethnic networks for inward FDI to China, E, SE Asia
  (Fan J Contemporary China 1998,*[1] Rauch JEL 2001)
- Western investors use Hong Kong as intermediary
  when investing in China (Li and Lian City U. WP 1999)
- Huwei, TCL looked for political (Russia, Vietnam) and cultural (SE Asia)
  affinity with destination countries (Chen and Lin 2008)
- In 1920s and 30s, Japanese textile firms in China were
  70% more productive than British in China, but less productive in home countries
  Used centralized management, intensive monitoring: better suited to local conditions

[1] Full citations are in paper

Statistical

- Cuervo-Cazurra and Genc (J Int Bus Studies 2008);
  Darby, Desbordes, Wooten (CEPR DP 7533, Nov 2009):
  Negative effect of bad governance on FDI is smaller when investing firms home country also has bad governance
- Hsiang-Chih Hwang (Working Paper 2010):
  Within-region investors to E and SE Asia less sensitive to country-risk, more to economic fundamentals

Will explore the idea in a model

Model – Extension of Javorcik and Wei, JIMF 2009

Firm F from origin (source) country O, considering FDI in host country H

$t =$ excess of level of F's technology in O over that appropriate for H

$r =$ level of corruption (defectiveness of governance) in H

F's choices: staying away Z, joint venture J, vertical integration V

revenue from project depend on mode: $R_V > R_J$

Production costs: $C_J = C_0 + c_j\, r + a_j\, t\,, \qquad C_V = C_0 + c_v\, r + a_v\, t$

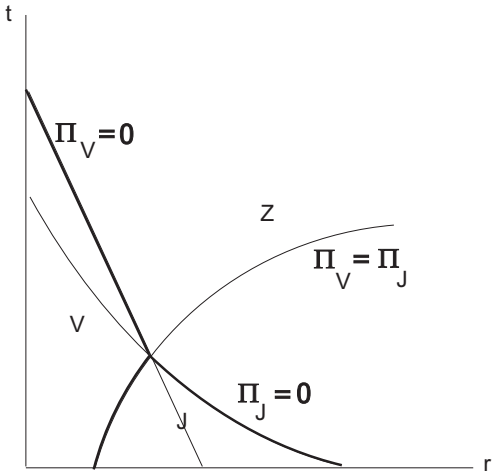
$C_0 =$ basic cost in H using most appropriate technology if perfect governance

Other terms: added costs for F to cope with H governance and technology

Local partner saves these costs: $c_j < c_v$, $a_j < a_v$

but creates expected cost of technology leakage: $L_J = \phi\, r\, t$

Profits: $\Pi_V = R_V - C_0 - c_v\, r - a_v\, t\,, \qquad \Pi_J = R_J - C_0 - c_j\, r - a_j\, t - \phi\, r\, t$

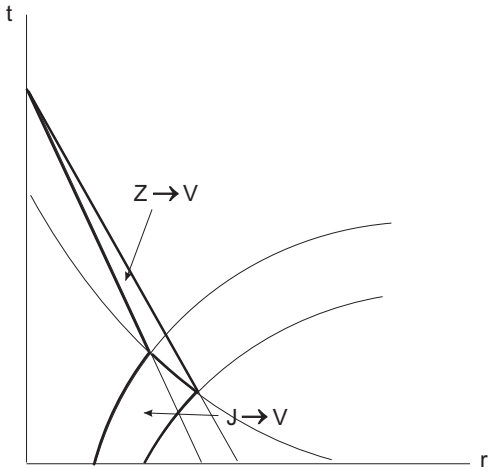


If Southern MNCs have better-adapted technology (lower t), possible differences between N and S:

N chooses Z, S chooses V

N chooses Z, S chooses J

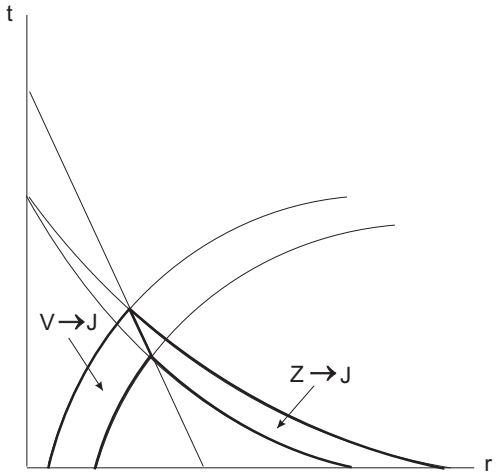
N chooses V, S chooses J



If Southern MNCs can directly better cope with bad governance (lower c_v), then possible differences between N and S:

N chooses Z, S chooses V

N chooses J, S chooses V



If Southern MNCs have better access to local partner who copes with bad governance (lower c_j), possible differences between N and S:

N chooses V, S chooses J

N chooses Z, S chooses J

More likely situation?

Concluding comments and suggestions

Offered an additional reason for success of southern MNCs:

Connections, experience and skill help cope with low-quality governance when investing in other southern or "lower north" countries

Policy implications for firms and governments:

Investors from North should cultivate local networks, partners.

Northern governments should seek treaties to safeguard firms' property, contracts.

Southern firms, governments can strategically use experience of coping.

Implications for researchers: new testable implications concerning destinations, organizational forms, and technological forms of South's outward FDI.

Need more, better data for testing