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

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Abstract

What determines whether countries' institutions attract or deter investment? Although existing theories predict that multinational enterprises (MNEs) avoid locations where institutions cannot constrain public and private actors' opportunistic behavior, we argue host institutions' attractiveness depends on firms' home environment. Home country institutions shape firms' practices and capabilities, thus helping to determine the environments that firms are best prepared to face abroad. 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, countries with low judicial independence disproportionately send FDI to countries lacking independent judiciaries. These findings' implications challenge conventional wisdom: "good" institutions may not attract all investors, and "bad" institutions may not always deter as current research suggests.

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What determines whether countries' institutions attract or deter investment? A large body of research on foreign direct investment (FDI) indicates that certain political institutions attract FDI by reducing investors' exposure to political and nonmarket risks. Across a variety of studies, there is broad agreement that political and legal institutions can encourage investment 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 2006, 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?

Political scientists have typically sought to answer such questions by seeking more finely-grained sources of institutional heterogeneity. For example, recent scholarship has helped to identify how legislatures within autocracies may encourage investment despite that regime type's perceived commitment problems (Wright 2008, Jensen, Malesky & Weymouth 2014). 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 the response to host institutions may depend on where investors are coming from (*home* countries).

Consider how conditions at home have shaped the investment strategies of Orascom Telecom, an Egyptian telecommunications company that invests in places that others often deem too risky politically. The executive chairman, Naguib Sawiris, recalls his decision to invest in Algeria although 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 the big deal?'...If you come from a risky destination, then the risk is relative." (Guillén, García-Canal & Fernández-Ménendez 2015, p.192).

This paper's central claim is that the benefits or drawbacks of particular political institutions to foreign investors are not absolute; instead, whether host institutions attract or deter FDI depends

in part on the institutions that investing firms have adapted to at home. Before investing abroad, firms develop a repertoire of strategies for 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 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 adopt practices and 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 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 incorporation, 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. 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 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 more 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' ability 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* environment as one such factor, we depart from political science research on FDI, which has focused almost exclusively on *host* countries. This theoretical move helps to highlight the growing presence of FDI from the developing world and provide a welcome counterbalance to theories and data that disproportionately emphasize developed-world experiences. Finally, while FDI research in political science often portrays firms narrowly, as cautious observers that either invest or not, this research reminds scholars that firms can and do adopt a wide range of actions to work within their nonmarket environment.

Institutions, FDI, and Growing Diversity among MNE Home Countries

As governments have increased their efforts in recent decades to attract FDI, social scientists have been drawn to the study of how host states' institutions shape investment decisions by generating or mitigating political risks. Scholars argue that firms avoid investment locations where formal institutions cannot credibly protect actors against expropriation by private actors or by the state itself. Instead, firms prefer locations with well-functioning institutions, such as strong courts, that can check opportunistic officials and allow businesses to defend their contracts and property rights in a timely, predictable manner (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 (Li & Resnick 2003, Jensen 2006). Nevertheless, we observe that many countries continue to attract significant levels of FDI despite lacking such institutions, even after controlling for important factors like natural resources or market size.

One explanation is that existing arguments overlook subtle, but important aspects of countries' institutional variation. Along these lines, recent scholarship examines 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). We contend that 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, particularly with respect to their institutional experience at home and the capabilities and strategies this engenders.[1]

We believe the prevailing emphasis in political science research on host, and relative inattention paid to home, institutions stems in part from a tacit and out-dated assumption that MNEs originate in the advanced economies of North America, Western Europe, or Japan, where political institutions are unusually effective at protecting rights and constraining public officials. Insomuch as these favorable institutional conditions are relatively homogeneous across such countries, there is little variation to spark researchers' curiosity about home country effects. Yet, with the steady rise of MNEs from developing and emerging markets, the global set of MNE home countries has grown increasingly diverse. We now observe significant institutional variation in FDI home countries, including many places where institutions are 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

Prior to investing abroad, firms 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 at home 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

[1]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).

institutional backgrounds. We develop this argument's logic here, then generate 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). 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 (Fisman 2001, Gehlbach, Sonin & Zhuravskaya 2010). 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 (Cuervo-Cazurra 2006). 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 (Bartlett & Ghoshal 1989, Rosenzweig & Singh 1991). 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 or else seek an alternative investment location (Bartlett & Ghoshal 1989, Jensen & Szulanski 2004).

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. 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 foreign investment requires some degree of adaptation, but 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. 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.[2]

Management researchers have been more attuned to home countries' influence in international investment (e.g. Cuervo-Cazurra & Genç 2008, Berry, Guillén & Zhou 2010). For example, Holburn and Zelner (2010) argue that firms from countries with weak political constraints seek out hosts with weak constraints because they have developed strong political capabilities for influencing policy-making. Instead of arguing that firms develop *stronger* capabilities when exposed to adverse conditions at home, we argue that firms develop *different* capabilities that are suited to their home institutions, whether strong or weak. Thus, our framework entertains the possibility that some firms may find "good" institutions less attractive because they cannot easily leverage those institutions to their advantage.

[2]Although home country experience is likely to be more fundamental in shaping firms' capabilities and strategies (Holburn & Zelner 2010), we acknowledge that firms' broader international experience may also be significant in this respect (Delios & Henisz 2003) and therefore control for firms' international exposure in the empirical analysis.

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.[3] 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). 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). 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 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*. For example, competitive companies typically rely heavily on cooperation among their legal, technical and managerial divisions to design contracts that protect their interests, creating firm-level expertise that grows over time through contracting experience (Mayer & Argyres 2004, Argyres & Mayer 2007, Bagley 2008).[4] Indeed, in such environments, inferior legal capabilities make firms vulnerable to those who understand how to 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.

[3] Following Linzer and Staton (2015), 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 greatly constrain other actors' choices.

[4] According to Argyres and Mayer (2007), contract design capabilities are thus a firm-level attribute and not "simply a matter of hiring the appropriate lawyers" (p.1072).

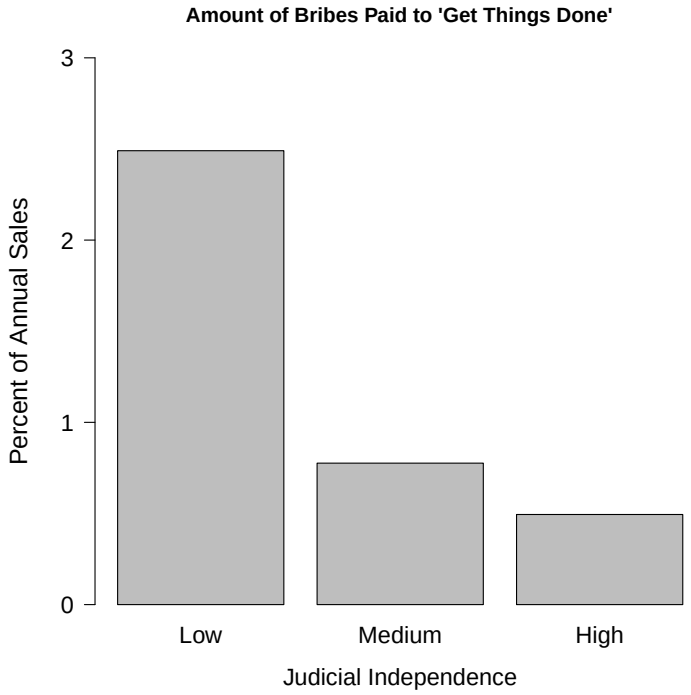
In contrast, where judicial independence is low, firms have few incentives to develop legal capabilities and instead develop alternative practices to protect themselves. For instance, firms may try to minimize vulnerabilities by avoiding credit, requiring upfront payments, or internalizing operations within the firm (Johnson, McMillan & Woodruff 2002, Acemoglu, Johnson & Mitton 2009). Alternatively, firms can use bribery to protect their interests, which requires developing routines and relationships that allow them to bribe effectively (Cuervo-Cazurra 2006). Informal commitment devices are also available to firms with experience in building networks and using informal institutions that leverage expectations of future exchange to limit contractual noncompliance (McMillan & Woodruff 1999*b*).

Survey data from the World Bank provide an empirical window into the prevalence of different practices under different institutions. In Figure 1's top panel, we see that, in countries with low judicial independence, firms are more likely to try to "get things done" by using bribery. Similarly, the bottom panel shows that firms operating amidst low judicial independence hedge against noncompliance by requiring a greater percentage of payments before or at delivery, rather than afterwards. Such evidence supports the theoretical claim that firms in different judicial environments choose different strategies to solve their problems and protect their interests.[5]

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 have developed strategies and capabilities that rely on effective courts, then we should expect those MNEs to prefer hosts with high judicial independence because these environments offer better opportunities to replicate their home operating practices. Conversely, MNEs from countries with low judicial independence do not develop business models that rely on independent courts and 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.

[5]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.

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



Note: Data from the World Bank Enterprise Surveys (2008-2011), using responses from 33,366 firms in 80 countries. Data on judicial independence from Linzer and Staton (2015).

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. 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 – 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 compete under more independent courts are ill-suited to environments where judicial independence is lower and informal practices play a major role in business dealings. For example, Kumar et al. (2005) detail how, despite shared ethnic and cultural ties, Singaporean firms' more legalistic approach has hurt their performance within the more informal setting of Chinese markets.[6] One Chinese manager 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).[7] Thus, for firms used to more independent courts at home, the difficulty of managing business relationships without independent host courts creates obstacles that deter investment.

[6]For more on foreign investors' frustrations with Chinese courts, see Wang (2015).

[7]Adaptation challenges also arise in the other direction. According to one American lawyer who worked for a Russian oligarch 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).

Conversely, successful firms from home countries with low judicial independence have home-grown skills – finding trustworthy partners, managing transactions without contracts, or bribing effectively – that can be useful elsewhere when judicial independence is also lacking, even when those environments differ 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 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. The ease of replicating this home-grown model in other environments also characterized by weak courts has allowed América Móvil to expand aggressively.

Possessing capabilities and strategies that work well under weak courts might affect MNEs' investment decisions in multiple ways. In the strongest version, MNEs with such skills could seek out "risky" locations because they would have a competitive advantage. 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.[8] 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.

[8]Given the current state of theory regarding firm-level preferences, we lack a principled way to privilege one theoretical explanation over the other. Ideally, future experimental or survey studies could explore these pathways that are effectively observationally-equivalent in our data.

Empirical Analysis

I. Firm-level Foreign Ownership Data

We begin testing our argument's empirical predictions using firm-level data on foreign subsidiary incorporations of 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).[9] This yields a baseline sample of 3,871 parent firms with newly-incorporated 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.

While data constraints on firm-level FDI typically push scholars to either focus on single sectors or industries or on MNEs from a particular home country, our dataset includes MNEs from across many industries and from 63 different home countries. This provides variation in home 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, leaving our dataset with 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.[10] Consequently, we treat the data as cross-sectional, representing a snapshot of MNEs and their foreign subsidiaries incorporated during the period of 2006-2011. Although incapable of revealing temporal dynamics, these data do allow our main 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 has a

[9] We drop all firms – parent and subsidiary – in tax havens because tax-haven activities typically do not reflect genuine investment. Likewise, we drop these countries from 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.

[10] 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.

subsidiary that was incorporated in its dyadic host country partner between 2006 and 2011 and a 0 otherwise.[11] 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, incorporation is an observable act that is comparable across contexts and avoids problems with inconsistent reporting standards and round-tripping that sometimes afflict aggregate FDI data (see Kerner 2014). Our baseline sample contains 10,409 instances of incorporation.

To measure judicial independence, we use the Latent Judicial Independence (LJI) scores from Linzer and Staton (2015). These measures are derived from item response theory models that infer underlying *de facto* judicial independence by leveraging multiple existing, yet imperfect, cross-national indicators as observable manifestations of that latent trait. LJI scores are continuous and bounded between 0 (completely dependent) to 1 (completely independent) and exist for all countries in our sample. Our main coefficient of interest is the interaction between home and host LJI. Before interacting the variables, we mean-center them so that the constituent terms' coefficients report home/host LJI's relationship with investment 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.

Based on existing research, we control for additional institutions associated with both judicial independence and investment decisions. First, we include the host's POLCON III measure of political constraints to capture formal political institutions' ability to constrain changes to existing policies (Henisz 2002).[12] Second, we include a dichotomous indicator of host democracy from Cheibub, Gandhi, and Vreeland (2009). Prominent arguments link both sets of 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 – including them provides a more conservative test of our argument.

We control for additional factors that may correlate with investment decisions and countries'

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

[12] In contrast to POLCON V, POLCON III does not include judicial constraints on policy making, enabling us to better isolate the effect of independent judiciaries.

institutional environment. These controls include host trade (as percent of GDP), 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.[13] We also include economic growth (percentage growth in GDP per capita) in the home country to account for low growth "pushing" firms to seek markets elsewhere.

Perhaps MNEs may simply prefer hosts 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, as economic exchange typically decreases with distance.[14] Having access to international arbitration may alter firms' concerns about hosts' domestic courts; accordingly, we control for firms' home having a bilateral investment treaty (BIT) with the potential host. Finally, we include firm-specific variables that might affect firms' investment abroad: total MNE assets (logged), MNE age (in years, logged), and a count of countries in which the firm already operates to account for firms' internationalization.

To analyze these data, we use multilevel logit models. Multilevel models' flexibility in modeling nested and cross-nested relationships is well-suited to 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 for these groups adjusts for nonindependent errors across repeated observations and helps ensure that our standard errors are properly large.

Results

For clarity, Table 1 presents results for only the main variables of interest; estimates for all other included covariates appear in the online appendix. Column 1 reports coefficient estimates from a model including only home LJI, host LJI, their interaction, plus varying intercepts for home

[13] These economic variables come from the World Bank's *World Development Indicators*.

[14] Data on distances, colonial history and common language are from CEPII: `http://www.cepii.fr/anglaisgraph/bdd/distances.htm`.

and host countries. Column 2 is the main model specification, which includes all control variables and adds random intercepts to adjust for industry-level heterogeneity. Column 3 adds additional intercepts for unobserved heterogeneity in reoccurring home-host dyads. The last column reports estimates after controlling for host/home interactions for both economy size and development. These additional interactions address concerns that independent courts merely proxy for key features of economic development, such as human capital or competitiveness. In this view, an interaction between home/host LJI might simply reflect productive (Western) firms seeking large markets or skilled labor in other rich countries; similarly, firms from poorer countries might have lower human capital or lower productivity and are thus only able to compete within less desirable locations. Including the additional home/host interaction terms helps to control more directly for these potentially confounding economic complementarities.

According to Table 1, firms' home judicial institutions condition the relationship between host judicial institutions and MNE investment. Across all models, the coefficient estimates on the interaction between home and host LJI scores are positive and statistically significant, as predicted by our argument. This implies that increased judicial independence in a potential host does not affect all firms similarly; instead, "good" judicial institutions' attractiveness depends in part upon MNEs' home environment. Higher levels of host LJI correspond to larger predicted probabilities of subsidiary incorporation for firms from high-LJI homes than for firms from low-LJI homes.

Figure 2 demonstrates the estimated change in predicted probability of subsidiary incorporation when we increase host LJI for firms at various values of home LJI (holding all continuous covariates at their means and discrete covariates at their medians). When firms' home courts have minimum independence,[15] improving a host's LJI from that of Romania or Bulgaria to levels found in Iceland, Japan, or Australia (sample mean to the max) increases the predicted probability of incorporation by 150% (from 0.008 to 0.020). In contrast, the corresponding change in predicted probability is nearly three times larger (420%; from 0.005 to 0.026) for firms from countries where courts have maximum independence.[16] Consistent with our argument, independent host courts are much more

[15]Examples in the lowest decile include Kazakhstan, Malaysia, and Egypt.

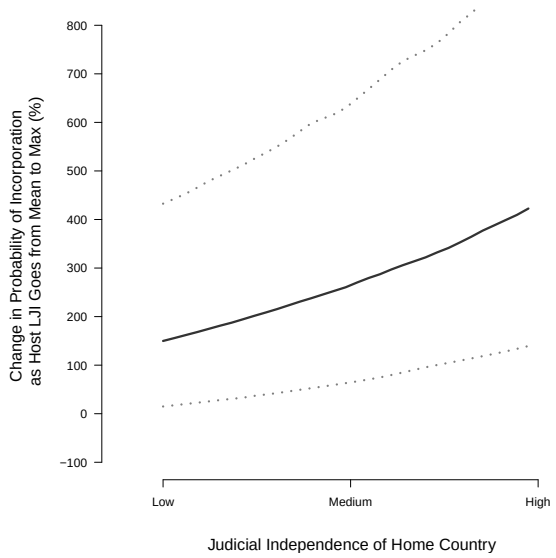
[16]The small scale of the predicted probabilities is common with dyadic analyses of infrequent events. New subsidiary incorporations are dwarfed by the number of potential hosts not chosen, making the probability of foreign subsidiary incorporation very low. In a context where hundreds of thousands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

Table 1: **Cross-sectional Firm Data: Multilevel Logit Models of Foreign Subsidiary Incorporation between 2006-2011**

DV: New Foreign Subsidiary Incorporation *dummy; 1 = subsidiary established*	(1)	(2)	(3)	(4)
Judicial Independence *LJI latent scale (0-1), mean-centered*				
Home × Host	1.918***	2.136***	2.816***	1.941***
	(0.305)	(0.402)	(0.579)	(0.447)
Home	−0.317*	−0.610***	−0.940***	−0.560***
	(0.167)	(0.205)	(0.271)	(0.210)
Host	5.078***	3.560***	3.636***	3.554***
	(0.443)	(0.910)	(0.890)	(0.911)
Political Constraints (Host) *POLCON scores, ranging 0 to 1*		0.519	0.329	0.522
		(0.837)	(0.818)	(0.837)
Democracy (Host) *dummy, 1 = dem.*		−0.108	−0.060	−0.110
		(0.402)	(0.393)	(0.402)
GDP per capita: (Home × Host)				0.011
				(0.010)
GDP, logged: (Home × Host)				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 regression models with random intercepts for home and host countries. Coefficient estimates for the control variables in models (2) through (4) are presented fully in the supplementary appendix. Model (4) includes constituent terms alongside the interactions. 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 1. Bands represent 95% confidence intervals, calculated via simulation.

attractive to firms from high-LJI countries than to firms from low-LJI countries.[17]

This analysis also provides insights into who invests in places with imperfect institutions. The constituent coefficient for home judicial independence is negative and significant. This suggests that when host LJI is at its 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 that deal with imperfect courts at home.

In addition to the main findings, we discuss the control variables briefly for general interest. The full tables in the appendix reveal that new subsidiary incorporation is more likely when home and host countries: share a common language or colonial history, are geographically close, and have a bilateral investment treaty. At the firm level, firms already operating in more host countries are significantly more likely to open new foreign subsidiaries. Economy size is the only statistically significant host-country predictor of subsidiary incorporation once we control for other factors.

changes of 0.01 or 0.02 in the predicted probability of incorporation are actually substantial.

[17]These marginal effects at low versus high values of home LJI are statistically different at $p < 0.001$.

Table 1's main findings are robust to alternative model specifications and estimation strategies. Our results are substantively similar if we 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 alternative operationalization using the absolute distance between home/host LJI scores (yielding a negatively-signed and significant coefficient). Results are similarly robust to controlling for home-host interactions for political constraints and democracy, hosts' natural resources (using fuel exports), the prevalence of North-North investment dyads, or using multiple imputation for missing data. We also find no meaningful changes after including home countries' uncertainty aversion profiles to account for investors' different risk tolerances (Hofstede 2001). We find similar results if we drop OECD host countries altogether; 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. Results for these additional analyses appear in the online appendix.

In this section, we have shown at the firm level that the attractiveness of host country institutions to investors depends upon the 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 extant arguments cannot fully explain how institutions attract or deter FDI without considering the conditioning effects of investors' home environment. In the next two sections, 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 FDI data.[18] Surveyed firms in participating countries report on foreign equity ownership in their enterprise and their own equity holdings in foreign countries. The IMF uses 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

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

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. Compared to typical cross-national datasets, the CDIS methodology appears to yield high-quality, comparable statistics on FDI stock. Moreover, the 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 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 these analyses is home country i's average total outward FDI position in millions 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 establish consistency across our analyses. To guard against bias and account for temporal lags in investors' decision-making, all right-hand-side variables are measured in 2008, the year before the first CDIS survey. We continue with the multilevel modeling approach and include random intercepts to control for unobserved home-, host-, and dyad-specific factors. Once more, we only display estimates for our main variables of interest, but full results appear in the online appendix.

Table 2 reveals consistent statistical support for our main argument. 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 attract FDI depends on investors' home judicial environment. The higher the home LJI score, the more positive the association between hosts' judicial independence and FDI. The marginal effects plot in Figure 3 demonstrates this conditional relationship.

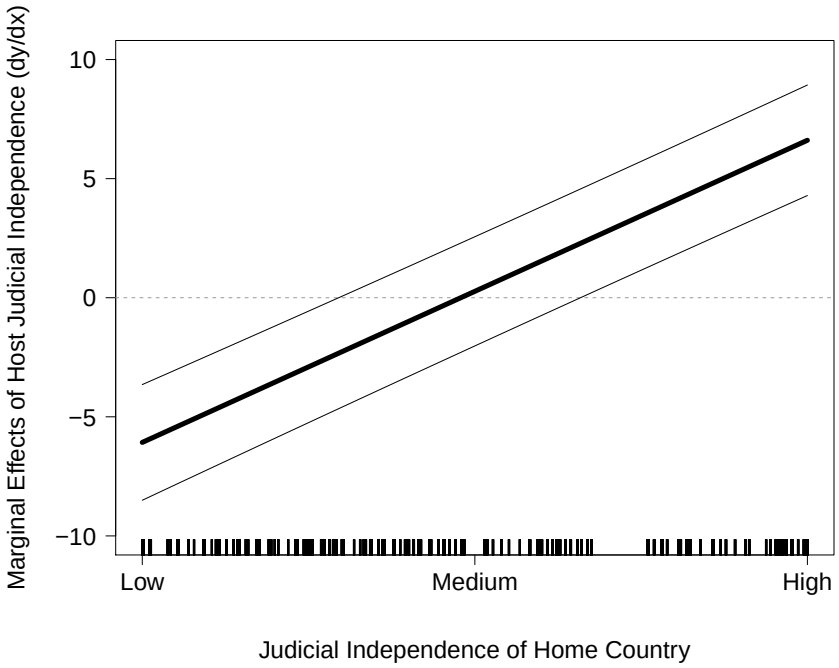
We have argued that firms from countries with low judicial independence develop capabilities well-suited to operating in other environments where courts are weak and ineffective. Figure 3's left side indicates that, all else equal, investors from lower-LJI countries invest less in higher-LJI hosts,

Table 2: **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***	13.060***	12.977***	9.718***
	(0.663)	(0.653)	(0.725)	(0.693)
Home	9.492***	3.486***	3.385***	3.821***
	(1.278)	(1.292)	(1.286)	(0.766)
Host	5.154***	0.912	0.895	1.298
	(1.255)	(1.167)	(1.143)	(1.145)
Political Constraints (Host) *POLCON scores, ranging 0 to 1*		−1.021	−0.906	−1.190
		(1.313)	(1.285)	(1.288)
Democracy (Host) *dummy, 1 = dem.*		1.374**	1.285**	1.349**
		(0.561)	(0.549)	(0.550)
GDP per capita: (Home × Host)				0.291***
				(0.025)
GDP, logged: (Home × Host)				0.188***
				(0.015)
Number of Observations	11,234	9,817	9,817	9,817
Number of Host Countries	166	141	141	141
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 regression models with random intercepts for home and host countries. Coefficient estimates for the control variables in models (2) through (4) are presented fully in the supplementary appendix. Model (4) includes constituent terms alongside the interactions. 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 2. Bands represent 95% confidence intervals.

where the judicial environment necessitates legal capabilities that they might not have developed. Whereas the firm-level results indicated less enthusiasm for independent host courts, the aggregate FDI data suggest that such firms may actually limit their investment in the presence of strong judicial institutions.[19] We have also argued that investors from countries with highly independent courts develop in ways that enable them to 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. All else equal, economic actors from high-LJI environments send more FDI to high-LJI host countries.

[19]While content to let the data to speak for themselves, we offer some thoughts on this apparent disagreement. One possibility is that the different outcomes – firm location choice versus aggregate investment amounts – reveal 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 than they would under different institutional conditions. The differences may also originate in the samples' data coverage. Because the IMF dataset includes roughly 100 more home countries and 50 more host countries than the Orbis data (all of them non-OECD countries), they may provide a more complete picture of how investment from various parts of the distribution respond to different host institutions.

We conduct multiple robustness tests on these models. The results do not change substantively if we analyze the data year-by-year or pooled together rather than as averages. Results are also robust to analyzing only non-OECD hosts, restricting the sample exclusively to non-OECD countries, excluding China, imputing missing data, or controlling for uncertainty aversion as before. Finally, because many directed dyads report a value of zero investment, one might question 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 any notable way. Results appear in the online appendix.

Overall, these analyses 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. 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 some 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 our hypotheses in longitudinal data on bilateral FDI flows.

III. Longitudinal Bilateral FDI Flows Data

As a final test, 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 two decades of FDI data. Although UNCTAD is currently the most extensive data source available on bilateral FDI over time, the dataset's main drawback is still limited coverage; UNCTAD provides bilateral FDI data for roughly 15% of dyad years between 1984 and 2006.[20] With this caveat, we construct a time-series

[20] As before, using multiple imputation provides similar findings to our main results. However, given the substantial missingness, we caution against generalizing from the UNCTAD data in isolation and consider these results only as

cross-sectional dataset, 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 three-year periods and use averaged values for each period to smooth out noisy annual fluctuations from "lumpy" investments. As above, we focus on the LJI measures and their home/host interactions as our main independent variables. We include the same set of control variables employed in the previous analyses, and 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. All models also include varying intercepts for time period to account for common shocks. Table 3 reports the results for our main variables of interest, and full results are available in the online appendix.

Looking at Table 3, we observe results that are consistent with both the firm-level subsidiary data and the cross-sectional FDI positions data – 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, indicating 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). Column 3 includes 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 and reduces the sample size, yet the interaction's coefficient estimate remains positive and statistically significant. Finally, the last two columns show results are robust to controlling for unobserved dyad effects or using annual data instead of three-year averages.[21] Moreover, the associated marginal

a longitudinal robustness check to our previous findings.

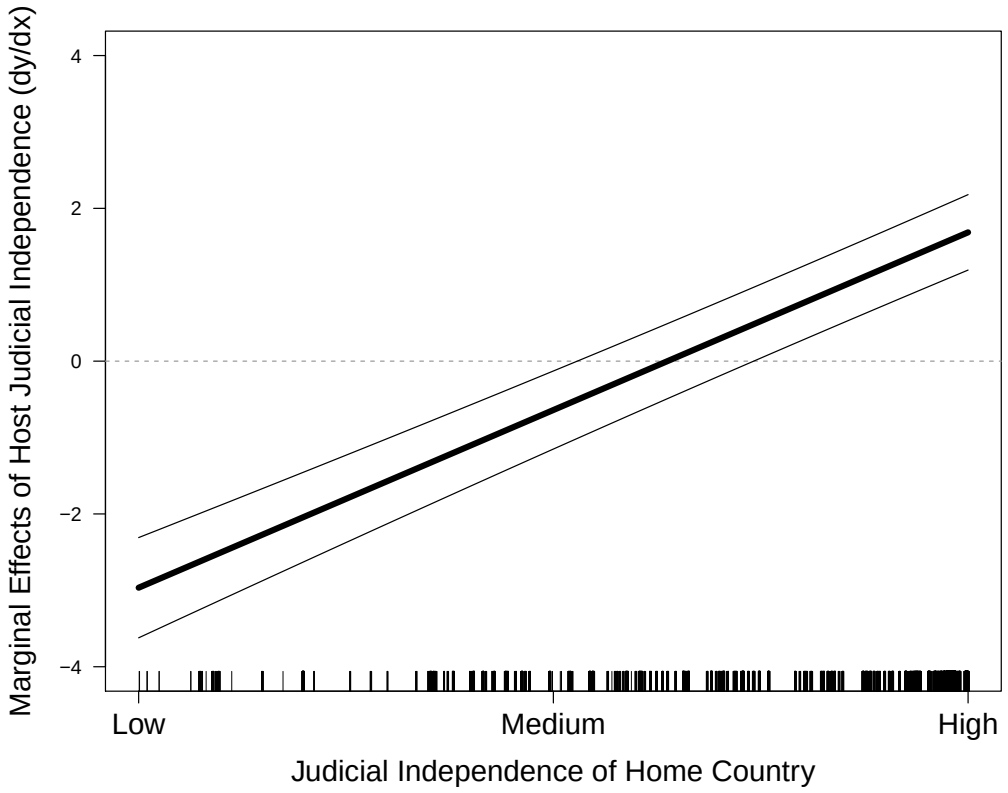
[21] Results in Table 3 are robust to the same alternative specifications described in previous sections. Furthermore, results are effectively unchanged if we analyze each time period separately, average over five-year time periods, or use a two-stage process to control for the predicted probability that a host receives non-zero FDI from a given home

Table 3: **UNCTAD Bilateral Data, Net FDI Outflows (1984-2006)**

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	1.194***	1.004**	0.448	1.130***	0.836**	1.431***
	(0.437)	(0.438)	(0.356)	(0.384)	(0.367)	(0.394)
Host	0.949***	−0.188	−0.321	0.263	−0.322	−0.062
	(0.228)	(0.253)	(0.172)	(0.248)	(0.231)	(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)				0.196***		
				(0.015)		
GDP, logged: (Home × Host)				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 regression models with random intercepts for home and host countries. Coefficient estimates for the control variables in models (2) through (6) are presented fully in the supplementary appendix. Model (4) includes constituent terms alongside the interactions. 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 3. Bands represent 95% confidence intervals.

effects plot in Figure 4 tells a familiar story: consistent with our argument, improved judicial independence in host countries appears most attractive to investment from home countries with highly independent judiciaries and least attractive to investment from countries with low judicial independence.

In this and the previous sections, we have tested our theory's main empirical predictions by triangulating across three independent and extensive pools of data: incorporation of multinational firms' 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, they suggest a striking implication: however desirable from the standpoint of

country. See appendix for associated results.

prevailing theories, robust and independent judicial institutions are not uniformly attractive to investors in practice. The effects of host institutions on FDI depends 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. The challenges of imperfect home institutions can prepare some economic actors to operate successfully abroad under institutional conditions that are considered too risky by 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 attractive for all multinational firms. This fresh perspective on the relationship between institutions and FDI has several implications for the literature.

First, this research suggests that the perceived benefits and drawbacks of host institutions depend partially upon where international investors come from. Independent host courts appear to be particularly attractive to investors who have independent courts at home. Similarly, host countries lacking independent courts disproportionately receive FDI from countries also lacking independent courts. These robust findings from different levels of analysis strongly suggest that, by ignoring heterogeneity among investing firms and their institutional background, much existing FDI research could be masking similar patterns.

Likewise, this paper's emphasis on MNEs' home institutions reminds scholars that FDI also originates from places besides the world's advanced democracies. 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 environment perceive the political risks associated with given host institutions. We hope that further research uncovers additional implications from the increasing variation among global investors that has accompanied the the growth of FDI from non-OECD countries.

Within political science, there are questions about whether globally-mobile capital encourages institutional convergence via pressures to reform (e.g. Mosley 2003, Quinn 1997). Our results hint that countries with "unattractive" institutions may face less pressure for institutional reform than previously acknowledged. As 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 messy institutional environments as they exist today.

Finally, although we have only had space to focus in detail on one type of institution in our discussion, we believe the argument's logic generalizes beyond judicial independence. Further research can also build upon these results by theorizing when skills and strategies developed at home transport across countries and when they do not. Furthermore, we consider FDI very broadly in our theory and empirics, but there may be important differences to discover using our framework with respect to firms' mode of entry or preferred type of investment.

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