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Governance, Development, and Foreign Direct Investment

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Abstract

Less-developed countries and transition economies wish to attract foreign direct investment (FDI), but are often handicapped by their weak governance structures, i.e. by insecurity of property rights and contracts. Potential investors and governments therefore attempt to devise alternative special arrangements and institutions that imperfectly substitute for good overall governance. The volume and form of investments adapts to the conditions and institutions of governance. Moreover, firms that have experience of coping with poor governance in their home country enjoy some advantage when investing in other host countries with similarly weak governance; this helps explain the emergence of outward FDI from developing countries. This lecture presents an overview of these issues and the related literature, and develops a simple theoretical model to improve our understanding of the emergence of multinational firms from developing countries.

Keywords

Foreign Direct Investment, Governance, Developing Countries, Multinational Firms.

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1 INTRODUCTION

The importance of good governance for economic development has been increasingly recognized over the last three decades by academics as well as policymakers. Economists, economic historians, political scientists, sociologists, anthropologists and legal scholars have studied the effects of poor governance on economic performance, and the alternative institutions that attempt to replace missing or ineffective formal state laws and the attendant enforcement machinery.ⁱ The World Bank and other organizations regularly publish various measures of good governance, in specific categories like corruption, rule of law, and quality of regulation, as well as broader ones such as ease of doing business. These measures receive wide publicity, and affect the attitudes of multinational firms to the desirability of investing in the countries surveyed. Many countries also pay serious attention to where they stand in these rankings, and their governments try to climb up to higher positions on the governance ladder with mixed success. However, in many less-developed countries and transition economies governance is seriously defective and likely to remain so for many years. Therefore, it is useful to take stock of our knowledge of how governance affects trade and investment.

The aspects of governance that are most relevant for my purpose here are the protection of property rights and the enforcement of contracts. To give a crude but illustrative picture of the deficiency and variability of governance over a broad sample of countries, I have taken three of the World Bank's six governance indicators that bear most directly on my concerns here – Regulatory Quality, Rule of Law, and Control of Corruption – for the years 2008-10, and averaged them. The results for a broad sample of countries are shown in Table 1.ⁱⁱ We see that most developing and transition economies fall below the median.ⁱⁱⁱ

Foreign direct investment (FDI) stands to suffer from poor governance in three ways. First, FDI pertains to property rights and contracts for a stock of capital, not just a flow over a few months or a year as in the case of trade in goods; therefore much more is at risk if governance is weak. Second, FDI often involves single large transactions between a firm-country pair, with less repetition than in the case of ongoing trade; therefore self-enforcing relation-based governance is less feasible for FDI than for trade. Third, foreign firms have reason to be more fearful about the protection of their property rights and contracts by host country governments and courts than do domestic investors, who have better access to the political processes of the host country. Indeed, governments sometimes use anti-foreigner actions strategically in their domestic politics, or at any rate employ rhetoric that creates fear of such action in the minds of the potential investors.

Despite all these problems and risks, a large amount, and on the whole an increasing percentage, of FDI flow goes to countries with imperfect governance, as Table 2 shows.^{iv} Some of these countries are also emerging as sources of FDI to other countries, and the destination countries often have their own governance deficiencies. The potential economic gains from these investments are clearly too large to “leave money on the table.” Therefore the firms making these investments and the host countries have evolved alternative institutions and arrangements. The firms have developed skills, and developed and used various networks of relational governance that enable them to cope with the risks, albeit imperfectly. They can parlay this advantage in their investments in other countries that have similarly defective governance. In this lecture I will review some of these mechanisms and outcomes.

2 PRECAUTIONARY OR CIRCUMVENTING ACTIONS

Weak governance generally works its damage by creating or worsening problems of commitment and moral hazard. Time-inconsistent incentives are key features of both these problems. Most mutually beneficial economic transactions require one or both parties to take actions that then expose them to opportunistic exploitation by their counterparties. They can write a contract that binds them to refrain from such actions – shirking on their obligations, holding an asset hostage to demand renegotiation of the division of the joint profits from the enterprise, and so on. But if the contract is not enforceable because governance is defective, the ex-post temptation to renege is unchecked. Knowing this, the

parties will be reluctant to enter the deal in the first place, and the mutually beneficial opportunity will go begging. In turn, knowing this, the parties will have ex-ante incentives to put mechanisms in place that will reliably bind them ex post. Of course ex post they will look for loopholes to gain more private profit at a cost to the other partners in the deal. This is the fundamental dilemma of governance. Let us examine a few devices that firms and governments put in place ex ante, in an attempt to reduce or overcome their ex-post temptations to violate property rights and contracts.

a. Choosing transaction forms

Different aspects of governance affect different forms of transactions differently. Therefore, firms can reduce their risks by choosing a form that is less adversely affected by the particular type of weakness in the governance structure they encounter. This is an application of Williamson's (1996, p. 12) discriminating alignment hypothesis: "Transactions, which differ in their attributes, are aligned with governance structures, which differ in their cost and competence, so as to effect a discriminating – mainly a transaction cost-economizing – result."

As an example, suppose property rights in a country are reasonably secure, but contract enforcement is problematic. Then foreign firms seeking to sell in that country will be wary of exporting using arm's length transactions, or licensing production to a local firm, but can relatively safely choose FDI. This has long been one of the standard transaction-cost-based explanations for FDI; the governance perspective clarifies exactly what kind of transaction cost is relevant in the context. Even within the category of FDI, there is a distinction between a wholly-owned subsidiary of the foreign firm and a joint venture in which a local partner has a large share entailing substantial control. Weakness of contract enforcement will tilt the foreign firm's decision toward using the former mode.

In Dixit (2011, pp. 198-200), I reviewed some empirical evidence showing the effect of governance on the volume and mode of FDI. Here is a brief summary.

Globerman and Shapiro (2002) found that, controlling for some other factors (GDP and some human development and environment quality indices), better governance leads to significantly more FDI inflows; the effect is especially strong for LDCs. Better governance in a country also increases its outflows of FDI, especially for large countries. The intuition is that better governance in the home country allows stronger and larger firms to emerge there, and they then become multinational and invest abroad. However, in the next section we will see an alternative hypothesis for south-south FDI.

Globerman and Shapiro (2003) consider FDI from the United States. Again, after controlling for other things, including some proximity measures (legal tradition, language etc.), they find significant positive effects of governance quality on both the probability of non-zero FDI (which conforms with intuition about the role of property rights) and the amount of FDI conditional on receiving any (which may be a net balance of two considerations about contract enforcement as mentioned above).

Henisz (2000) obtains separate estimates for two forms of FDI: joint ventures and majority-owned subsidiaries. He also makes a distinction between hazards of contract enforcement and other political hazards. The two interact in joint ventures: a local partner firm can use its political influence to get away with cheating the foreign firm. He finds some, albeit weak, support for this hypothesis using data on FDI by U.S. manufacturing firms.

Javorcik & Wei (2009) estimate equations for the binary entry decision and, conditional on entry, for the mode (wholly owned subsidiary versus joint venture). The determinants include corruption in the host country and the R&D intensity of the industry. Corruption tilts the decision away from entry but, conditional on entry, toward a joint venture. High R&D intensity increases the risk of technology leakage and therefore favors a wholly owned subsidiary. They find substantial effects of this kind, and some interaction between the two: the effect of R&D intensity favoring the wholly owned mode is stronger in more corrupt countries. I examine a related theoretical model in Section 4.c.

b. Using intermediaries

A foreign investor may be able to reduce the risk of being cheated by local firms by using an intermediary who has a relationship with those firms. Many such intermediaries are parts of ethnic networks or diasporas. “When courts cannot be trusted to enforce contracts, people prefer to deal with those they have confidence in. Personal ties make this easier” (*The Economist*, 2011 d). Li and Lian (1999, section 3.2) argue that Hong Kong prospered during the 1970s and 80s by playing such a role, linking Western investors and mainland Chinese manufacturers. The Hong Kong financial and business communities had a part in both governance traditions: they were able to deal with Westerners using formal contracts, and with officials and firms in mainland China on the basis of ethnic networks and relationships. The Rothschilds played a similar role in Europe (Ferguson 1998, 1999) and the Morgans – father and son – in the 19th century linked European lenders with U.S. manufacturers who needed to borrow (Strouse 2000).

c. Commitment Devices for Host-country Governments

Outright expropriation of foreign investments is relatively rare these days, but foreign firms’ property can be insecure in various ways. The repatriation of profits can be restricted; tax regimes can be changed. Some of these must be accepted as normal hazards of policy shifts. But more pertinently, rights and licenses for natural resource exploration can be revoked (*The Economist*, 2011 a). To reduce these risks and attract more investment, governments can tie their hands using Schelling-like commitment devices. Monaldi (2002) gives the example of the Venezuelan oil company PDVSA. To attract FDI into its heavy oil fields in the 1990s, it offered the collateral of its offshore receivables in northern countries. It also had outward FDI holdings – oil refineries in the U.S. and Europe, assets of its wholly-owned subsidiary Citgo in the U.S. – that were at risk if it reneged on the terms of its inward FDI. This kept its hands tied even after the government changed and Chavez came to power.

d. Bilateral Investment Treaties

States that are unable to improve their overall standard of governance may nonetheless be able to reduce the risks to foreign investors by concluding bilateral investment treaties (BITs) with the governments of countries from which they wish to attract direct investment. Such treaties have proliferated in the last half-century. The first one was between Pakistan and West Germany in 1959; now there are nearly 3,000. Although FDI is a private contractual relationship between two firms, BITs frame these relationships by imposing obligations on host states that reduce the investors’ perception of governance hazards. Most BITs work by giving the investor foreign firms the standing to file actions for damages against host states before a specified international arbitration tribunal such as the World Bank’s arbitration facility, the International Center for the Settlement of International Disputes (ICSID). The host country’s government, as a signatory to the New York Convention or the ICSID convention, undertakes to enforce the ruling of the tribunal.

BITs pose many interesting researchable questions, for example: (1) How do they work, and how effective are they as a way to increase FDI? (2) Do they go too far, or not far enough? (3) Why have they not paved the way for a multilateral agreement like the GATT or WTO? I have space here only for very brief remarks concerning these.

BITs primarily offer recourse to foreign investors against actions by host country governments, rather than enforcement of clauses in their private contracts with host country firms. Host country governments are also complex entities with different tiers that have jurisdiction over different aspects of an investment project, and the top tier that is the signatory to the BIT may be de facto ineffective against the politics or bureaucracy of lower levels. Nevertheless, BITs may act as signals of host governments’ resolve to maintain an investor-friendly domestic environment. Tobin

and Rose-Ackerman (2011) discuss the credibility of this commitment and test the hypothesis empirically. They find that countries that sign BITs do attract more FDI. But the marginal effect of a country's own BITs on its FDI inflows is smaller when there are more BITs worldwide. In other words, competition from other BIT countries reduces the special attractiveness of any one BIT country to foreign investors.

This raises the possibility that countries, in their efforts to attract FDI, may be trapped in a prisoners' dilemma. They may sign BITs that give foreign firms more and more rights, going well beyond the protection that their domestic firms enjoy, and giving foreign firms protection against the kinds of changes in regulation and taxation, including regulatory taking, that are normal hazards of doing business even in northern countries with very good governance. Some have criticized BITs as an encroachment on the sovereignty of the governments of less-developed countries. Some ceding of sovereignty for the sake of improved regional or worldwide coordination – an internalization of policy externalities – should and does occur in many contexts, including international trade, environmental protection, and monetary policy. But there are good reasons to be concerned about BITs. Montt (2009) argues that these treaties, and their interpretation by arbitration tribunals, “may end up being more protective of investors' rights than *developed* countries' own legal systems” (p. 23, emphasis in the original). Foreign investors should not be protected from bearing the costs of policies that affect all firms and that are promulgated by legitimate governments.

However, BITs may have a beneficial by-product: they may create a ‘halo effect’ of international investment law that then leads to improvement in the overall governance in the host country; then domestic investors gain security to match the treatment given to foreign firms (Montt 2009, p. 78).

Montt (2009, Introduction) points out that unlike much domestic law, BITs do not lay down specific or concrete rules, but only some general abstract standards. However, several important features are common to most BITs; these, together with decades of experience, have created a case law or common legal practice. This may make a multilateral agreement less necessary. Also, an agreement that supersedes an existing set of bilateral treaties would have to provide all parties with more surplus than they get at present. As bilateral agreements proliferate, such possibilities narrow. The potential gain from a multilateral agreement may no longer cover the costs of negotiation (Bubb and Rose-Ackerman 2007).

3 THE EMERGENCE OF SOUTHERN MULTINATIONALS

The usual, and often unstated, assumption in the literature on FDI is that the multinational corporation (MNC) making the investment is based in a developed, industrialized, rich “northern” country.^v Its advantage is attributed to R&D, technology, and management. These are usually non-contractible for reasons of information asymmetry and difficulty of verifiability. The host country for the FDI may be another northern country that has some location-specific production advantage, or a “southern” country whose main advantage comes from low labor costs of the manufacturing and other low-tech stages of production. Some of these activities may also be non-contractible because the relevant information is non-verifiable. FDI, or cross-border vertical integration, replaces informationally infeasible external contracts with internal corporate governance. This is not costless: there are agency costs within the firm. But it may be better than the risks of unenforceable external contracts or insecure property rights.^{vi} The MNC will then choose the optimal mode of operation, taking into account transaction costs as well as production costs.

However, this view of the typical multinational as a northern firm investing in other northern countries as well as southern ones is increasingly at odds with reality. Over the last three decades, southern multinationals have emerged as substantial investors in other southern countries, and have begun to make significant investments in northern countries also. Many headline-grabbing acquisitions such as Lenovo buying IBM's PC business, Mittal buying Arcelor, and Tata Motors buying Jaguar, may in fact create the impression that the flow of FDI has totally reversed direction. The reality is less dramatic but still striking, as Table 3 shows. Outward FDI from developing countries has been a

sharply rising proportion of total FDI outflows. Transition economies are smaller but even more rapidly rising contributors to this flow. The nature of such FDI is also changing, from being mainly in natural resource industries to being much more broadly based (Mlachila and Takebe 2011).

These facts deserve closer scrutiny and research. Do southern multinationals and FDI have any special characteristics? Can their rise be explained by standard theories, or would understanding of the rise benefit from new concepts and models?

Research is accumulating on these and other questions of outward FDI from the south, for example Sauvant, McAllister and Maschek (eds.) (2010). But the phenomenon of southern multinational FDI caught the attention of researchers quite early. Two books published in 1983, by Lall et al. and Wells, found that these firms had several distinctive features: southern MNCs (a) are smaller, (b) use technologies and management better adapted to local conditions and factor prices, (c) have better-developed managerial skills to deal with low-skilled workers, (d) are more likely to engage in joint ventures with firms or businesspeople in the host country, and (e) are more likely to engage in bribery of local officials.

They also found several explanations, not mutually exclusive, for outward FDI from capital-poor countries. In no particular order, these are as follows. (a) A difficult regulatory and governance environment in the home country reduced the desirability of reinvesting profits there and made FDI more attractive. This was an especially relevant consideration for Indian firms in the 1970s and 80s. (b) The firms were responding to an approach by host country governments, which preferred a southern MNC to one from an imperialist or former colonial country. This was relevant for some African countries in the 1970s. (c) The southern firms used FDI to acquire modern technology. This was more relevant for southern FDI into advanced countries. (d) The firms used FDI to acquire natural resources or land rights; this has been especially relevant for recent Chinese investments in Africa and the Middle East. (e) In the last two categories, the firms are encouraged or subsidized by their home country governments, which want to acquire the technology and resources as a matter of national policy.

Here, I wish to explore yet another possible explanation, intended to supplement the ones mentioned above and not to exclude any of them. This is the idea that southern firms have learned from their home country operations how to cope with difficult conditions and bad governance. This gives them an advantage when investing in other countries with similar conditions and institutions. Thus the hypothesis is intended as a possible explanation for southern FDI into other southern countries, or ones with mid-level economies and governance institutions, rather than for southern FDI into northern countries with truly superior governance.

4 ABILITY TO COPE WITH DEFECTIVE GOVERNANCE AS A SOURCE OF ADVANTAGE

The experience of operating in difficult economic environments, and under bad governance institutions, helps southern firms cope with similar conditions elsewhere in many ways. (a) They have adapted their production technologies to the conditions of their country. They can better manage unreliable supply chains, unreliable power supplies, low-skilled and diverse workers, and so on. (b) They know the importance of contacts and relationships to navigate regulatory obstacles and weak contract enforcement, and have experience in doing so. The relationships and networks in the countries where they propose to invest may work differently than in their home countries, but their experience enables them to learn, explore and master the new conditions more quickly than can northern firms, which are used to smooth transactions with strangers ensured by formal governance mechanisms. (c) Southern firms have better access to ethnic and linguistic networks in the target countries than do northern firms. (d) Southern firms are used to bribery in their home countries, and not normally constrained by their home-country laws in their foreign operations. Northern firms are often subject to such laws, and also to their home country's anti-corruption cultural norms and pressure from home NGOs. Northern firms do attempt to get around these restrictions by using local "facilitators" to do the bribing on the firms' behalf, so the bribes appear on the firm's books as

consultancy fees. However, this merely shifts the firms' governance problem to one of choosing reliable facilitators. Also, northern NGOs are getting wise to this device, making it harder to use. Thus, southern firms retain some advantage from their own experience and their local ethnic networks. (e) Northern firms also face similar pressure in their home countries to pay fair wages to their workers in the south; southern firms can go along with the prevailing conditions in the host country.

In this next section I review some evidence bearing on these advantages of southern firms, and construct a model based on them.

a. Narrative and historical evidence

The advantage that comes from the experience of working under tough conditions has been well understood in the business community: "if you can make money in India you can make it anywhere" (*The Economist*, 2011 c). And it is even taught in some business schools: "Skolkovo in Moscow is Russia's leading business school ... Its MBA prepares students for the vagaries of doing business in what Wilfried Vanhonacker, the school's Dean, describes as 'difficult economies', such as Russia, China and India. The school gives a candid account of graft, institutional gaps, and limited availability of talent" (*The Economist*, 2011 b).

The importance of Chinese ethnic networks for inward FDI to China and other countries in east and southeast Asia is well known (Fan 1998, Rauch 2001). Chinese outward FDI has exploited another kind of experience; Chen and Lin (2008) discuss how Huawei and TCL sought out, and benefitted from, political (Russia, Vietnam) and cultural (SE Asia) affinity with destination countries.

Nor is the phenomenon recent. Zeitz (2011) compares the performance of British and Japanese-owned textile firms in China in the 1920s and 30s. The British firms' home factories were much more productive than those of the Japanese firms, but this was reversed for the operations in China, where the Japanese firms enjoyed a 70% advantage in total factor productivity. This was because Japanese management practices, with centralized management and intensive monitoring, were better suited to Chinese conditions than the British approach, which was much more decentralized and relied on subcontracting. Corruption was rife in China, and could flourish at lower levels of management under the British system. For example, in British-owned mills foremen were given the responsibility for hiring, and took on excess workers in exchange for kickbacks; these workers then idled and fomented trouble. The Japanese absorbed foremen's functions into specialized personnel offices under Japanese (or better-trained and closely supervised local) managers, and production was under the control of trained technicians. Zeitz cites similar differences between Japanese and British firms operating in China in other industries, such as coal mining.

b. Econometric evidence

The idea that the disadvantage of dealing with poor governance at home can become an advantage when investing in other similar countries was, to my knowledge, first suggested and tested by Cuervo-Cazurra and Genc (2008). They, and Darby, Desbordes and Wooten (2010), found that the negative effect of bad governance on FDI is substantially smaller (less negative) when the investing firm's home country also has bad governance. Hwang (2010) found that within-region investors to E and SE Asia are less sensitive to country risk, and more to economic fundamentals, than are investors from outside this region. This suggests that they are better able to cope with the difficult conditions, including bad governance, that give rise to country risk.

Amighini, Rabellotti and Sanfilippo (2011) use detailed industry and host country data to study China's outward FDI. Among other determinants, they study the effect of host country corruption, and find that it differs across groups of countries. Controlling for other determinants, the association between the probability of receiving Chinese investment and the level of corruption in the host country is negative for high-income countries but positive for low-income countries. This may be

due in part to the fact that many low-income resource-rich countries have high levels of corruption and much Chinese investment in these countries is in resource industries. However, they find that the effect exists also in manufacturing investments, suggesting that Chinese firms' ability to cope with bad governance is part of the explanation.

c. Theoretical modeling

I will explore the implications of the hypothesis using a modification of the model in Javorcik and Wei (2009). Consider a firm contemplating direct investment in a country whose governance quality is expressed by an inverted measure τ , so higher τ corresponds to worse governance quality. The firm has a technology too complex or advanced for the economic conditions in the country; let t denote the excess. The firm has three choices, staying out (labeled Z), establishing a wholly-owned subsidiary (vertical integration V), and entering a partnership with a local firm (joint venture J).

The firm faces two kinds of costs in addition to the usual costs of production: those of coping with the bad governance and those of adapting the technology to the local conditions. These are higher when τ and t are higher. A local partner's knowledge of the country's conditions can reduce these costs. To keep the algebra simple without affecting the qualitative results, I assume simple functional forms for these coping and adapting costs under the two modes:

$$C_V = c_v r + a_v t, \quad C_J = c_j r + a_j t,$$

where $c_v > c_j$ and $a_v > a_j$.

However, the bad governance creates the risk that the partner steals the technology and then uses it to set up competing exports back to the firm's home country. The leakage costs would be zero if the country had perfect governance ($\tau = 0$) or the multinational's technology were perfectly adapted to the country's conditions, eliminating the risk of competition back in the firm's home market ($t = 0$). Therefore a simple form for the leakage costs is

$$L_J = \phi r t.$$

Suppose the multinational firm's profit, leaving aside the coping, adapting and leakage costs discussed above, would be R_V and R_J under the two modes, where $R_V > R_J$ because the local partner must be given a share. Then the overall profits of the modes are

$$\begin{aligned} \Pi_V &= R_V - c_v r - a_v t, \\ \Pi_J &= R_J - c_j r - a_j t - \phi r t, \end{aligned}$$

and of course $\Pi_Z = 0$.

For each (τ, t) combination, the multinational firm will choose the mode that yields it the best profit. Many configurations are possible depending on the parameters, but to save space I focus on the one that yields the most intuitively reasonable comparative statics results.^{vii} This is shown in Figure 1. The curves labeled $\Pi_V = 0$, $\Pi_J = 0$ and $\Pi_V = \Pi_J$ divide the (τ, t) space into regions. Π_V is positive to the left of the curve $\Pi_V = 0$ and negative to its right; Π_J is positive below the curve $\Pi_J = 0$ and negative above it; and $\Pi_V > \Pi_J$ above the curve $\Pi_V = \Pi_J$ and $<$ below it. Then we can read off the regions in the space where each of the choices V, J, and Z is optimal. In the figure, these regions are separated by thick curves and labeled with the optimal mode choice.

When r and t are sufficiently high, profitable operation is not possible under either mode. When r is low, the firm does better by using vertical integration to avoid leakage costs. But when t is low, the local partner's ability to cope with bad governance becomes the more important consideration.

With this basis, we can now compare the choices facing a northern firm N and a southern firm S contemplating investment in the same southern country. First consider technology differences. If the typical southern multinational has been using a technology in its home country that is better adapted to

the conditions of the target country than that of a northern multinational, then in Figure 1 S will be located vertically below N. Depending on r , various differences between these two firms' choices can arise. For low r (relatively good governance in the target country), N may stay out while S enters using V or J, or N may enter using V while S enters using J. For higher r (worse governance), N may stay out while S enters using J. These comparisons broadly conform with the observation of the Wells (1983) and Lall et al. (1983) studies cited above, that southern multinationals are more likely to enter into joint ventures with local partners.

Next consider the hypothesis that southern firms are better able to cope with poor governance. They may be able to do so either on their own, or because they have better access to a network of local firms who have the requisite contacts and experience. The former can be captured in the model by giving southern firms a smaller c_v than northern ones, and the latter by giving them a smaller c_j . The first possibility is analyzed in Figure 2, and the second in Figure 3.

In Figure 2, a lower c_v shifts the $\Pi_v = 0$ curve to the right, and the $\Pi_v = \Pi_j$ curve downward. This expands the region where V is optimal, at the expense of both the Z and the J regions. Therefore, in the region bounded by thick lines and labeled $J \rightarrow V$, a northern firm would enter using mode J while a southern firm with its lower c_v would enter using mode V. This happens in countries with reasonably good governance, and for firms with fairly advanced technology. Similarly, in the region bounded by thick lines and labeled $Z \rightarrow V$, a northern firm would stay out while a southern firm would enter using mode V. This is the case if the country has reasonably good governance and the firm's technology is not too advanced relative to what is appropriate in the country.

In Figure 3, a lower c_j shifts both curves $\Pi_j = 0$ and $\Pi_v = \Pi_j$ upward. This expands the region where J is optimal, at the expense of both the Z and the V regions. Therefore, in the region bounded by thick lines and labeled $V \rightarrow J$, a northern firm would enter using mode V while a southern firm with its lower c_j would enter using mode J. Similarly, in the region bounded by thick lines and labeled $Z \rightarrow J$, a northern firm would stay out while a southern firm would enter using mode J. Both these shifts occur if the firm's technology is not too advanced relative to the needs of the target country; the former in countries with reasonably good governance, and the latter for countries with worse governance.

This suggests that the tendency observed by Wells (1983) and Lall et al. (1983), namely that Southern multinationals are more likely to form joint ventures with local partners, is better explained by their access to such partners than by their own skill in navigating the difficult conditions and governance in the target country. Of course this is a very rough test, and in reality firms in different industries and different countries are likely to possess both kinds of advantage to different extents. Therefore, more refined tests are needed, and that in turn needs much more and detailed data.

More generally, this theoretical analysis and modeling suggests further hypotheses. For example, the relative advantage of southern multinationals over northern ones is likely to be greater in those industries where governance is more important. This advantage can in turn be related to similarities in the home and host countries of the FDI: common ethnicity and language, similarity of political systems, and so on. All this creates new and interesting possibilities for empirical research.

5 CONCLUDING REMARKS

The direction and nature of FDI flows is changing rapidly. Southern countries, formerly mainly recipients of FDI from the north, are increasingly becoming significant sources of outward FDI. Various defective governance in southern countries affects the volume and form of their inward FDI. But these very deficiencies have given their firms experience of coping with difficult conditions. They have used this experience, and their ethnic and linguistic links with other southern countries, to better secure their outward FDI to these countries, which have similar governance problems. These developments create valuable and interesting opportunities for research, and hold the promise of yielding ideas for institutional reform. In this lecture I have outlined some of these issues and opportunities, and hope that this will generate interest that leads to progress on academic as well as policy fronts.

TABLES AND FIGURES

Table 1 – Governance in a Sample of Countries

Source: Author's construction from World Bank data, as explained in the text
http://info.worldbank.org/governance/wgi/mc_countries.asp

Accessed 21 December 2011

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	Canada	96.06
China	43.24	Denmark	99.47

Table 2 – Inward FDI annual averages

Source: UNCTAD <http://unctadstat.unctad.org/TableViewer/tableView.aspx?ReportId=88>

Accessed 22 December 2011

Years	World Total \$ million	Developing countries		Transition economies	
		\$ million	% of world	\$ million	% 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

Table 3 – Outward FDI annual averages

Source: UNCTAD <http://unctadstat.unctad.org/TableViewer/tableView.aspx?ReportId=88>

Accessed 22 December 2011

Years	World Total \$ million	Developing countries		Transition economies	
		\$ million	% of world	\$ million	% 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

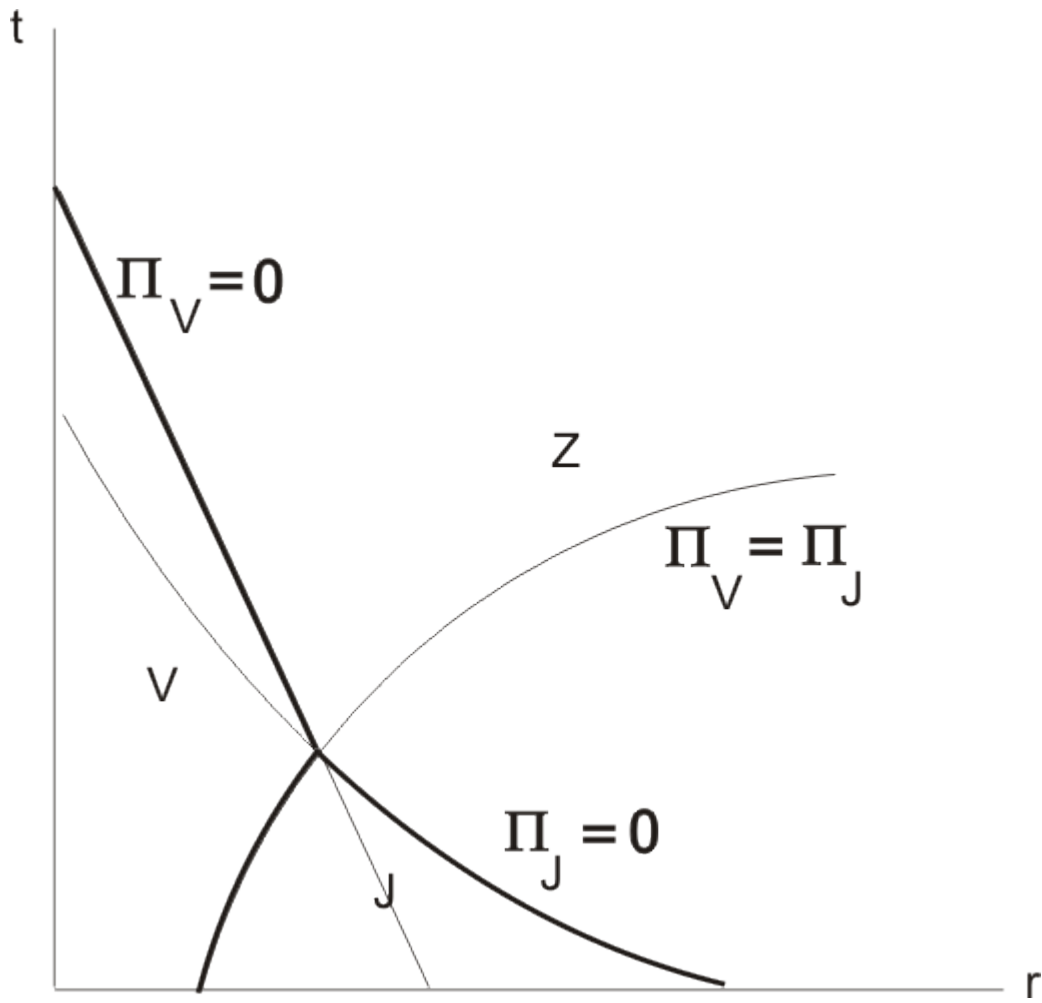


Figure 1 – Optimal Modes of Investment

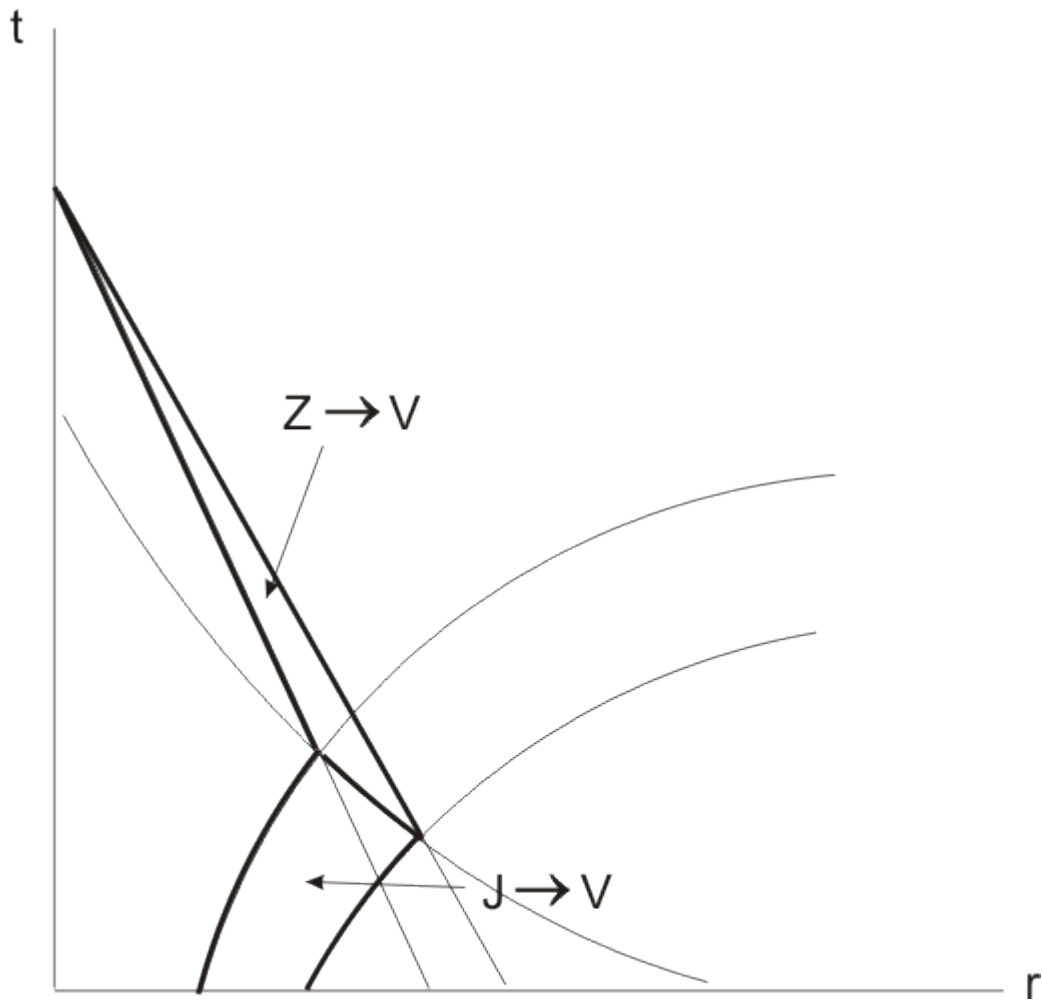


Figure 2 – Effect of Own Ability to Cope with Bad Governance

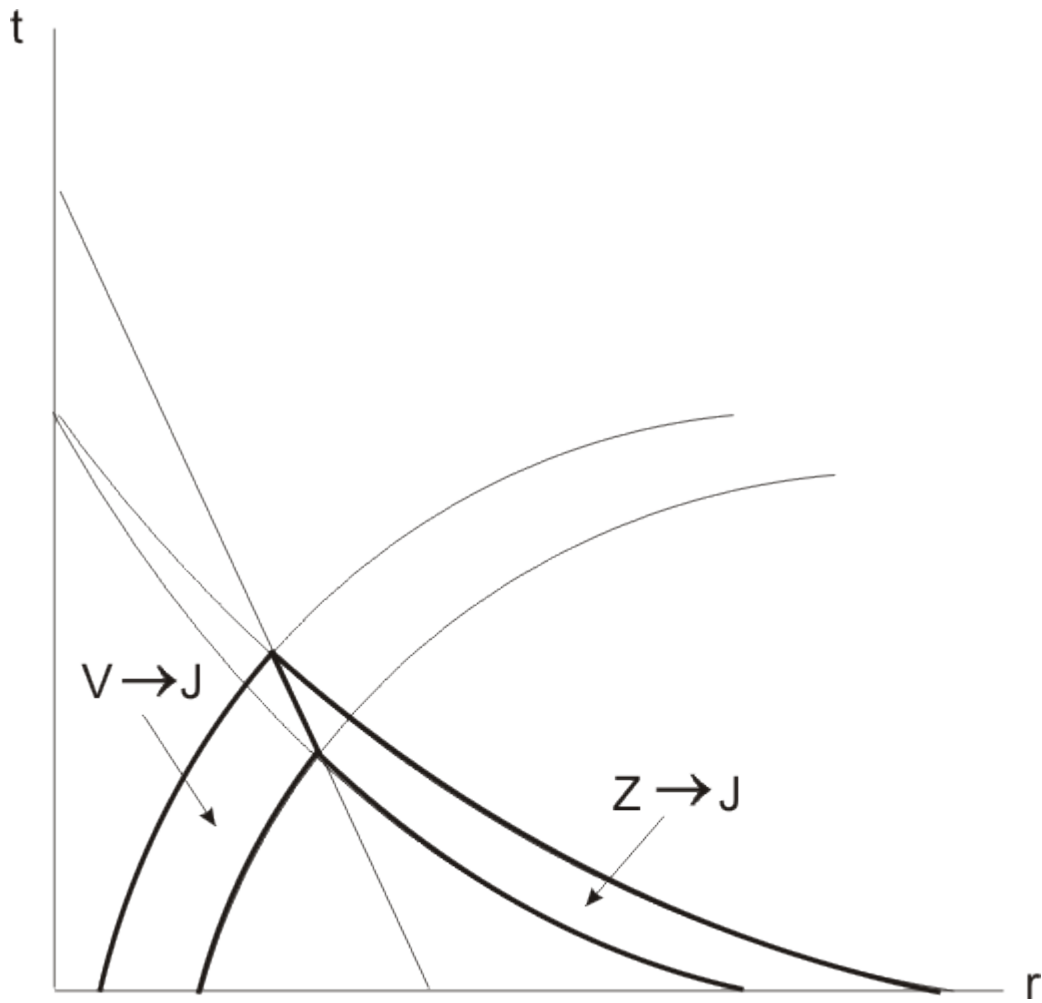


Figure 3 – Effect of Local Partner’s Ability to Cope with Bad Governance

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ⁱ Some of this literature is surveyed in Dixit (2004, 2009).

ⁱⁱ The other three – Voice and Accountability, Political Stability and Absence of Violence, and Government Effectiveness – are relatively more political, and bear less directly on issues of property right protection and contract enforcement. But their inclusion would not change the picture significantly.

ⁱⁱⁱ The very high ratings of some advanced countries may be misleading because some of them have indirect forms of corruption such as closed networks of elites and insiders.

^{iv} The data shown are for all developing countries and transition economies. These vary greatly in their quality of governance; therefore the procedure is very imperfect. But as we saw above from Table 1, these countries on the whole have low levels of governance. A substantial research project would be needed to classify the data according to categories of governance quality, and the crude data serves my very limited purpose here. Five-year annual averages are used because any one year’s FDI has substantial accidental variation; for example, one large project may be launched or end, or a multinational firm may change its listing from one country to another, thereby switching an investment from the domestic to the foreign category or vice versa.

^v For brevity, I shall adopt the “northern” and “southern” terminology that is commonly used in the literature in this context. However, it should be clear that the distinction is not geographic, but one based on economic performance and governance standards. Thus, in this context, Australia is in the north and Russia in the south!

^{vi} Thus the standard theory of FDI is basically Williamsonian transaction cost economics in an international context. But its development took place in parallel and somewhat independently; see Dunning (1981) and Caves (1996).

^{vii} Specifically, the figure shows the case where $\frac{R_Y}{c_e} > \frac{R_Y - R_I}{c_e - c_f} > \frac{c_e - R_I}{\phi}$. Other possibilities are left for the interested reader to explore.

