

THE RELATIONAL EFFECT OF THE RULE OF LAW: A COMPARATIVE STUDY OF JAPANESE AND SOUTH KOREAN FOREIGN DIRECT INVESTMENT

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ABSTRACT

Building on institutional theory, this paper examines the relationship between the relative rule of law of home and host countries, the home country's institutional frame and foreign direct investment (FDI). We suggest that firms based in countries with a higher level of rule of law will invest more FDI per capita in host countries with comparable or higher levels of legal protections. Further, companies based in countries with a lower rule of law are accustomed to lower degrees of institutional safeguards. For these latter countries, the comparable levels of rule of law between home and host country will not as strongly impact FDI per capita. We test our logic through an examination of FDI from two home countries with different levels of rule of law: Japan (high) and South Korea (medium). Using FDI data from Japanese firms in 114 countries and South Korean firms in 118 countries, we find that while rule of law is a predictor of FDI per capita, the relative nature of the rule of law between home and host countries in higher rule of law home countries is also important. In addition, we discover that companies from Japan, a high rule of law country do seek out similar or higher rule of law environments for higher levels of FDI per capita investments while companies from a medium level rule of law country, South Korea, are less beholden to institutional standards. Our study contributes to the literature looking at the impact of country-level factors on foreign investment decisions, suggesting that it is the comparative rather than absolute values that are important to understand as well as the institutional environment in the home country.

Keywords: Rule of law, Japan, South Korea, foreign direct investment

INTRODUCTION

As governments compete to keep their domestic businesses investing at home and develop incentives to attract foreign investment, institutional conditions such as the rule of law can have a strong impact on a firm's assessment of investment risk in host countries (Biglaiser & Staats, 2010; Globberman & Shapiro, 2003; Wang, Xu, & Zhu, 2012). Research has indicated that the presence of the rule of law and

the protection of property rights are drivers of economic growth and investment, even more so than political democracy (Barro, 2000). Furthermore, it has been suggested that a host country's rule of law is an important antecedent to critical aspects of national economic growth, such as entrepreneurship, capital accumulation, innovation, and human capital (Globerman & Shapiro, 2003; Scully, 1988).

However, the rule of law is not a constant across country boundaries; it is both constructed from and impacted by unique institutional forces that alter the cost of doing business (Dunning & Lundan, 2008; Henisz & Swaminathan, 2008; Pajunen, 2008). The composition of the rule of law differs between countries and impacts choices available to both domestic and foreign organisations. As noted by Scott and Davis (2007, p. 322), "choices of [company] strategy take place against a backdrop of law and public policy that allow and encourage some choice, and limit or prevent others." Organisations make choices that recognise that the institutional environment defines controls and restricts organisational behaviour. This environment can include the legal attributes of the institutions that shape societies.

Attention in the international business literature has been focused on understanding the influence of institutional conditions in the host country on attracting or repelling foreign direct investment (FDI) (Arregle, Miller, Hitt, & Beamish, 2013; Chan, Isobe, & Makino, 2008; Ghemawat, 2001). There has also been an examination of the (dis)similarity between home and host country institutions, a construct termed institutional distance (Kostova, 1999; Kostova & Zaheer, 1999). The difference in institutional distance has been theorised to impact country choice and the multinational enterprise (MNE) entry strategy (Xu & Shenkar, 2002). High institutional distance between home and host countries is believed to cause high coordinating costs, making these host countries less attractive FDI targets (Jackson & Deeg, 2008). Nevertheless, in the context of the rule of law, the foreign investment decision may be more subtle. In particular, do the regulative legal conditions in the home country influence investments by MNEs in possible host countries? As noted by Henisz and Swaminathan (2008, p. 539), "Firms' responses and their performance implications to a given institutional construct will vary according to multiple criteria including aspects of a firm's prior experience in its home country institutional environment as well as those of other countries in which it has operated". We advance the premise that while the rule of law in a potential host country is an important consideration for FDI decisions by MNEs, the regulative institutional conditions in the home country will influence where MNEs make foreign investments. In essence, companies in countries with high-level rules of law will make different FDI per capita investments than companies in countries with mid-level rules of law.

To examine this premise, we consider a home country with a high-level rule of law (Japan) and a country with a lower-level rule of law (South Korea). We select these East Asian countries based on their similarities and their differences, as well as their economic importance in the Asia Pacific region (Kim & Lee, 2007; Rios-Morales & Brennan, 2007). Both countries are located within the same broad region and have companies that actively engage in FDI across a wide geographic spectrum. However, as measured by the WGI rule of law index, their rules of law are different, with Japan having a high-level rule of law (1.35) compared to a medium level for South Korea (0.69), creating conditions that allow for cross-country comparisons. As a broad measure, we considered high rule of law countries to be those who are in the 70th percentile or higher of the WGI rule of law index, medium rule of law countries to be those in the 40th to 69th percentile, and low rule of law countries to be those below the 40th percentile. As point of reference, Japan occurs in the 86th percentile of all countries, and Korea is in the 66th percentile.

The rule of law developed somewhat differently in each of the countries; thus, a closer examination of the differences in the rule of law between the two countries may help demystify the institutional forces that impact foreign investment from a *home* country perspective. While Japan and South Korea are on the receiving end of significant FDI, an examination of their rules of law allows for a better understanding of what Japanese and South Korean firms may be looking for in host countries, beyond determinants such as industry and market-seeking motives.

THEORY AND HYPOTHESIS DEVELOPMENT

While cross-national studies have considered a variety of dimensions, including cultural, linguistic, institutional, and political elements (Berry, Guillén, & Zhou, 2010), it is the consideration of institutional elements that is gaining significant traction amongst international business scholars (Berry et al., 2010; Biglaiser & Staats, 2010; Buckley, Cross, Tan, Xin, & Voss, 2008; Chan, Makino, & Isobe, 2010; Dunning & Lundan, 2008; Henisz & Swaminathan, 2008; Jackson & Deeg, 2008; Makino, Beamish, & Zhao, 2004; Pajunen, 2008; Peng, Wang, & Jiang, 2008; Xu & Shenkar, 2002). Institutions have been defined as representative of the rules of the game of society, or more formally, human-devised constraints that shape human intervention (North, 1990). These interactions can vary from the formal (constitutions and laws) to the informal (norms of behaviour and self-imposed codes of conduct). Institutions that are able to direct capital to its most productive uses, including property rights and an effective legal system, are the most successful in making a nation more competitive (Mishkin, 2006).

Within this institutional context, the rule of law is an important determinant of country legitimacy. The rule of law serves to protect against anarchy, allows people to plan their affairs in advance so that they can know the legal consequences of their actions, and provides some protection against the arbitrariness of state officials. While it is broadly agreed that the rule of law incorporates several elements, including "a respect for and enforcement of property rights, the functioning of agencies for the enforcement of law and maintenance of order, policy and customs, and the judiciary" (Nwabuzor, 2005, p. 127), there is no seminal definition of the rule of law in management literature (O'Donnell, 2004).

Foreign investors look at a host country's rule of law level, amongst other factors, as they determine where to place their funding (Globerman & Shapiro, 2003; Pajunen, 2008; Wang et al., 2012). As noted by Prime, Subrahmanyam and Lin (2012, p. 321), the "government is critical for competitiveness since it sets policy, but other supporting institutions such as the legal system are critical for sustaining competitive advantage for any nation." Thus, the rule of law becomes an important country-level driver of growth as FDI is generally held to benefit the host country by providing new job opportunities, increasing technology transfer, and complementing domestic investment (Chakrabarti, 2001; Chowdhury & Mavrotas, 2006). At the same time, both domestic and foreign investors want to know that their investment will be protected by the laws and the enforcement of the laws in respective countries. Legal systems protect investors from expropriation either by organisational insiders or by external entities, such as governments (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Nwabuzor, 2005).

National competitiveness can be characterised by institutions that provide the ability of a firm to respond to its environment (Witt & Lewin, 2007). To the degree that the institutions of a country constrain a firm's ability to respond to the environment, a company can partially escape these institutions by employing FDI in those countries that have better institutions than the home country (Witt & Lewin, 2007). One of the foundations that enables a firm to respond to its environment is the rule of law. The weaker the rule of law in a host country, the less a company is able to protect its assets in that country. As the level of the rule of law in the host country increases, the risk associated with transaction costs, investment protection, investor rights, monitoring, and enforcement decrease even further, making the host country even more attractive for FDI (Haggard, MacIntyre, & Tiede, 2008; La Porta et al., 2000). The establishment and enforcement of legal rules create an institutional environment at the country level that signals legitimacy to out-of-country investors. If the host country's institutional environment is weak, that host country will find it more difficult to

attract investment (Keefer & Knack, 1997). Thus, we suggest the following hypothesis:

H1: The level of incoming FDI per capita in a host country will be positively related to the host country's rule of law.

While theory suggests that in an attempt to reduce risk and uncertainty, a home country's firms will endeavour to invest in a host country with a higher rule of law, this is likely not the only factor influencing outbound FDI decisions. As noted by Dunning and Lundan (2008, p. 586), "national level institutions affect the attractiveness of a given country both as a host and home to MNE activity". The national institutional framework in the home country could create a familiarity and ease with, as well as a capability of, operating in institutional environments that are similar. Recent research has demonstrated that MNEs from developing countries are more present and successful in other developing countries than their counterparts from developed countries (Cuervo-Cazurra & Genc, 2008). As such, companies used to a particular home country environment may, under certain conditions, seek out host countries with institutional environments more similar to their own, rather than those with more developed institutional frameworks.

Institutional theory posits that organisations in similar institutional environments will begin to resemble each other as they respond in similar ways to regulatory or normative pressures (DiMaggio & Powell, 1983). Within the international business literature, institutions have been considered to be part of the country-level environment (Xu & Shenkar, 2002); thus, we consider MNEs within a country as a collective. The national institutional environment within which the MNEs are embedded creates broad, country-level approaches to business. As noted by Orru, Biggart and Hamilton (1997, p. 153), "in East Asia, private businesses operate according to substantively distinct institutional models that differentially shape organizational behaviour and structure." As such, there is a broadly similar approach to risk and uncertainty manifested by companies in specific countries that is grounded in the home country's institutional environment. This should be evident in the discrete ways in which MNEs approach and operationalise their FDI decisions. We believe this to be a nuanced difference from the institutional difference construct; while the relative institutional difference between the home and host countries is relevant, we suggest that the institutional conditions of the home country may influence the choice of host countries for FDI investments.

In our consideration of the regulative pillars of countries, we look to the foundations of the domestic rule of law in Japan and South Korea to provide explanations for differences or similarities in FDI patterns. The legal systems in

Japan and South Korea are influenced by the German Commercial Code, written in 1897 after the unification of Germany. As noted by La Porta, Lopez-de-Silanes, Schleifer, and Vishny (1998, p. 1116), "civil laws give investors weaker legal rights than common laws do, independent of the level of per capita income." Countries with German civil law foundations are believed to provide only mid-level protection to investors. However, a reaction to weaker laws can be the stronger enforcement of them, which is evidenced in countries based on German civil law structures (La Porta et al., 1998).

Even though both Japan and South Korea have similar legal origins, there is a clear bifurcation in terms of their institutional development. Post World War II, Japanese laws were considered to have been significantly influenced by the American legal system, particularly in terms of corporate law (La Porta et al., 1998). American legal systems are predicated on a strong protection of investors and an equally strong protection of property rights. This influence on Japanese legal systems created more rigorous protections for business, mitigating uncertainty and risk. In the 1980's, economic upheaval, political instability and changes in the banking industry led to a stronger institutionalisation of Japan's legal system as a way of solving challenges. As suggested by Milhaupt (1996: 50), "legal rules and institutions [were] inserted into patterns of conduct once governed principally through a highly relational order." This strengthening of Japan's rule of law is also evident when one considers its international ranking on rule of law measures; in particular, Japan consistently ranks significantly higher on rule of law indices than South Korea (Kaufmann, Kraay, & Mastruzzi, 2007). Thus, the fact that there are differences in institutional norms in these home countries' legal framework and institutions could lead to different preferences in terms of foreign investment. Thus, we suggest the following:

H2: The home country's rule of law will positively moderate the relationship between the rule of law in the host country and its inbound FDI per capita such that the relationship will become stronger and more positive for a home country with a higher level rule of law and will become weaker for a home country with a lower level rule of law.

We put forward that the institutional conditions of the home country, on their own, impact FDI decisions by MNEs. However, the comparative difference between institutional conditions in countries is another potential input into FDI decisions. Institutional distance departs from the more conventional economic explanations for FDI by focussing on the difference between institutional conditions in home and host countries as the key decision factor for FDI decisions (Xu & Shenkar, 2002). Recent research has begun to examine the relative nature of institutional comparisons, suggesting that companies that have managed to

survive weaker institutional environments may be more successful in host countries with similar environments than companies from stronger institutional environments (Cuervo-Cazurra & Genc, 2008; Kostova, 1999). This speaks to a more complex relationship than just that of institutional difference: it is not only the differences between the two countries, it is how the institutional environment in the home country shapes how leaders of firms view the institutional environments of host countries.

Figure 1 provides the theoretical model proposed in Hypothesis 2.

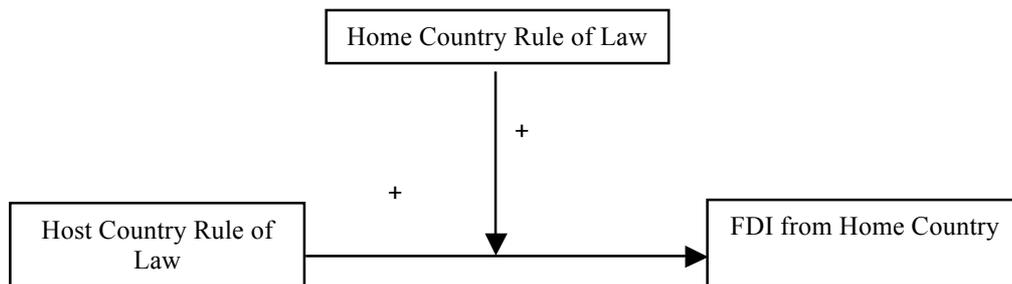


Figure 1. Impact of home country rule of law (Japan, South Korea) on the relationship between host country rule of law and outbound FDI per capita by the home country

We advance the argument that the relationship between the home country's rule of law and the level of FDI is more complex than just the absolute difference in institutional levels. Because the rule of law has been demonstrated to be an institutional precondition for investment (Haggard et al., 2008; Hewko, 2002), we suggest that in the competitive market for FDI, countries would be grouped into two segments: those with a rule of law that is higher or equal to the host country's rule of law and those with a rule of law that is lower than that of the host country. It is the threshold that is important rather than just the differences between the institutional conditions. This relational nature of the rule of law between the home and host country interacts with the host country's rule of law to influence the level of FDI the host country attracts.

The advantage of adopting a threshold approach over one that only considers an absolute comparison is particularly valid in cases where the institutions are stronger in the host country than in the home country. Considering institutional distance does not deconstruct the advantage of being above or below the home country. Host countries with more advanced rules of law than the home country enjoy, by their relative nature, stronger institutional certainty (Slangen &

Beugelsdijk, 2010). Investors are aware that they will have stronger protections than if they invest domestically. However, it is important to recognise that this does not necessarily mean the rule of law is high in the host country; rather, it is just higher than that of the home country, which could be quite low.

In situations where there is uncertainty about the possible outcomes of an investment decision, the response of investing companies may be to avoid the situation completely (Kobrin, 1979). We assert that this state of uncertainty exists in those countries where the rule of law is lower than that of the home country. Uncertainty created by inconsistencies in the reaction by legal systems and institutions in a host country will make it challenging for an investing company to understand and determine the possible outcomes and the respective probabilities of the success of their investment decisions (Cuervo-Cazurra & Genc, 2008; Slangen & Beugelsdijk, 2010). As the rule of law decreases relative to the home country, uncertainty regarding investment protection, investor rights, monitoring, and enforcement increases. From the multinational home office perspective, these institutional risks and uncertainties would debilitate the inflow of FDI per capita (Stoian & Filippaios, 2008).

If we extend this logic, we would expect MNEs based in countries with a high rule of law to seek out host countries with a similar or higher rule of law in which to make FDI per capita investments. MNEs based in these high-level rule of law home countries are used to and expect all the protections and certainty that comes with these higher rule of law jurisdictions. They will want host countries that offer the same or higher level of investment protection through clearly articulated laws, enforcement mechanisms and a fairly administered justice system for their higher level FDI per capita investments. Therefore, the threshold for the rule of law remains important.

MNEs based in countries with mid-level rules of law may not be as discriminating because their home country institutional environment has provided them with the experience and ability to work within environments with a greater variance of regulative uncertainty. If companies have less certainty around business practices because of weaker legal systems in their home country (e.g., no intellectual property protection), they must become used to navigating within this environment if they are to survive. As such, it may be that companies from home countries with a lower rule of law do not view the rule of law in host countries to be as critical to their FDI per capita investment decisions as do companies based in home countries with a higher rule of law. Therefore, we would expect to see companies located in home countries with mid-level rules of law to be comfortable investing in a wider variety of host countries, i.e., both those with lower and higher levels of the rule of law than their own. Thus, we suggest the following:

H3: The positive relationship between the rule of law in the host country and its inbound FDI per capita (see H1) will be moderated by the relative rule of law between the two countries such that where the rule of law in the host country is higher than the home country's rule of law, the relationship will be stronger and more positive, whereas for host countries where the rule of law is lower than the home country's rule of law, the relationship will be weaker.

Figure 2 provides the theoretical model proposed in Hypothesis 3.

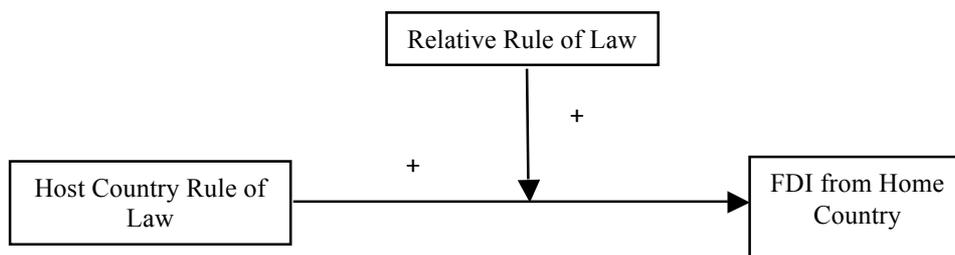


Figure 2. Impact of the relative host country rule of law (above or below that of the home country) on the relationship between the host country rule of law and outbound FDI per capita by the home country

METHODOLOGY

Dependent Variable

FDI per capita

The dependent variable, FDI per capita, was defined as the amount of Japanese and South Korean FDI invested per capita in a particular country. By examining FDI on a per capita basis, we are able to build in a control for country size. The use of FDI per capita as a dependent variable is prevalent in international business research on the determinants of FDI from an economic and institutional perspective (Fan, Morck, Xu, & Yeung, 2009; Harms & Ursprung, 2002).

Data on Japanese FDI were obtained from material published by Toyo Keizai, Inc. of Japan, which includes investment data of Japanese subsidiaries around the world and is published on an annual basis. The Toyo Keizai (TK) database

contains cross-sectional information on the subsidiaries of over 5,000 Japanese parent firms and has been used extensively in previous research (Voyer & Beamish, 2004). Data on South Korean FDI were obtained from material collected and published annually by Korea Eximbank. Japanese investments in 114 countries and South Korean investments in 118 countries were included in this study. Population data were sourced from the World Bank database.

Independent Variables

Host country's rule of law

Due to the breadth and robustness of the sampling methodology, we used the World Bank's Worldwide Governance Indicators (WGI), in particular, their rule of law index. The WGI provides an evaluation of the broad rule of law conditions (Pajunen, 2008; Skaaning, 2010). The WGI contains information on 212 countries and territories and is aggregated from hundreds of specific and disaggregated individual variables from 33 different data sources provided by 30 different organisations. The advantage of using an index rather than individual indicators is that the use of multiple measures allows for the inclusion of more countries, enabling comparisons across a broader set of countries (Kaufmann, Kraay, & Zoido, 1999). In addition, aggregate indicators are more reliable than individual indicators. The WGI rule of law index was compiled from 960 business information providers, 371 surveys of firms or households, 410 non-governmental organisations and 655 public sector organisations for a total of 2,396 data sources. The median number of sources per country for the rule of law was 11, with indices available for 202 countries and territories (Kaufmann et al., 2007). Using the single year (2003) for WGI rule of law indices was deemed appropriate for this analysis (Voyer & Beamish, 2004), as an examination of the available rule of law indices for the countries included in this study indicated that they have been relatively constant over time.

Home country's rule of law

To test our hypothesis that the institutional nature of the rule of law in the home country impacts the relationship between the rule of law in the host country and the amount of FDI per capita, we created a binary variable where 0 was the rule of law in South Korea and 1 was the rule of law in Japan.

Relative rule of law

Whether a host country's rule of law is higher or lower than that of the home country could impact the willingness of a home country to invest in that jurisdiction. Hypothesis 3 requires that the population of countries in our sample be divided into two groups: (1) those that have a rule of law index value equal to or greater than the home country's rule of law index value and (2) those that are less than the home country's rule of law index value. The WGI rule of law index also provides standard errors for all of the index values; to determine the relationship between home and host countries' rule of law indices, these standard errors were considered (Kaufmann et al., 2007). The Japanese rule of law index value for 2003 was 1.35 with a standard error of 0.14. Therefore, the lower limit of the Japanese rule of law index score was set at 1.21. The South Korean rule of law index value for 2003 was 0.69, with a standard error of 0.16. Therefore, the lower limit of the South Korean rule of law index score was set at 0.53. For every host country in the Japanese and South Korean sample, we added their standard error for the Rule of Law Index for 2003 to their rule of law index value to arrive at their adjusted value. We then created a binary variable where 1 equals host countries with rules of law equal to or higher than the home country and 0 equals countries with lower rules of law than the home country.

To account for other possible influences, we included GDP per capita, government consumption, the inflation rate, labour growth, cultural practices and values, and industry as control variables.

Statistical Analysis

In all of the models, FDI per capita was the dependent variable. The independent variables (depending on the model) included the host country's rule of law, the home country's rule of law (constructed as a binary for Japan or South Korea) and the relative rule of law (above or below the home country). The aforementioned control variables were included in all of the models. To ensure the ability to cross-compare variables constructed through different methods, all continuous independent and control variables were standardised or centred where appropriate. The correlation matrix is presented in Table 1.

Table 1
Descriptive statistics and correlations

| | <i>M</i> | <i>SD</i> | <i>N</i> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|----------|-----------|----------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|------|
| 1. FDI per capita | 40.0 | 287.2 | 231 | 1.00 | | | | | | | | | | | |
| 2. Host Country Rule of Law | .05 | 1.01 | 232 | 0.30** | 1.00 | | | | | | | | | | |
| 3. Home Country Rule of Law (Binary) | 0.5 | 0.5 | 232 | 0.21** | -0.01 | 1.00 | | | | | | | | | |
| 4. Relative Rule of Law (Binary) | 0.2 | 0.4 | 232 | 0.24** | 0.76** | -0.22** | 1.00 | | | | | | | | |
| 5. GDP per capita | 5,729.8 | 7,724.3 | 228 | 0.29** | 0.79** | -0.01 | 0.74** | 1.00 | | | | | | | |
| 6. Government consumption | 15.1 | 5.4 | 226 | 0.20 | 0.49** | 0.01 | 0.39** | 0.48** | 1.00 | | | | | | |
| 7. Inflation rate | 11.6 | 32.2 | 220 | -0.15* | -0.49* | 0.02 | -0.31** | -0.34** | -0.33** | 1.00 | | | | | |
| 8. Labour growth | 1.7 | 1.3 | 231 | -0.08 | -0.31** | -0.04 | -0.28** | -0.13* | -0.20** | -0.02 | 1.00 | | | | |
| 9. Culture | 9.6 | 1.8 | 232 | 0.06 | 0.34** | 0.53** | 0.15* | 0.32** | 0.27** | -0.13 | -0.21** | 1.00 | | | |
| 10. Host country agriculture value-added | 14.9 | 14.6 | 220 | -0.18** | -0.60** | 0.01 | -0.40** | -0.52** | -0.40** | 0.30** | 0.28 | -0.31** | 1.00 | | |
| 11. Host country industry value-added | 30.1 | 11.0 | 221 | -0.09 | -0.06 | -0.03 | -0.08 | -0.02 | 0.02 | 0.06 | 0.13* | -0.02 | -0.39** | 1.00 | |
| 12. Host country service value-added | 54.0 | 15.4 | 219 | 0.25** | 0.61** | 0.02 | 0.43** | 0.51** | 0.40** | -0.31** | -0.34** | 0.29** | -0.71** | -0.32** | 1.00 |

** Correlation is significant at the 0.01 level (2-tailed)

* Correlation is significant at the 0.05 level (2-tailed)

Table 2
Results of regression analysis^a

| | Model 1 | Model 2a (Hypothesis 1) | Model 2b | Model 2c | Model 2d | Model 2e | Model 3 (Hypothesis 2) | Model 4 (Hypothesis 3) |
|--|-----------------------|----------------------------|-----------------------|---------------------|----------------------|----------------------|---------------------------|---------------------------|
| Independent Variables | | | | | | | | |
| Host country rule of law | | 21.12 [‡] | 21.55 [‡] | 24.29 [‡] | | 19.05 | -5.17 | 21.72 |
| Home country rule of law | | | 74.56 ^{***} | | 78.25 ^{***} | 76.42 ^{***} | 65.16 ^{***} | |
| Relative rule of law | | | | -18.54 | 30.17 | 14.61 | | -101.28 [‡] |
| Host country rule of law * | | | | | | | 55.13 ^{***} | |
| Home country | | | | | | | | 77.11 [*] |
| Host country rule of law**Relative rule of law | | | | | | | | |
| Control Variables | | | | | | | | |
| GDP per capita | 35.42 ^{***a} | 22.25 [*] | 26.58 [*] | 26.57 [*] | 29.99 [*] | 23.28 [‡] | 0.00 ^{**} | 0.00 |
| Government consumption | -18.14 [*] | -19.67 [*] | -16.05 [*] | -19.60 [*] | -14.81 [*] | -16.02 [*] | -3.29 ^{**} | -3.31 [*] |
| Inflation rate | -2.77 | -0.54 | -0.73 | -0.21 | -3.01 | -0.99 | -0.01 | -0.02 |
| Labour growth | 1.12 | 3.06 | 2.44 | 2.71 | 1.48 | 2.71 | 1.23 | 3.07 |
| Cultural practices and values | -4.59 | -4.74 | -28.80 ^{***} | -5.67 | -28.36 | -28.67 ^{**} | -9.87 | -4.52 |
| Host country agriculture value-added (as % of GDP) | -5.02 | 5.14 | -4.64 | 5.35 | -13.37 | -5.06 [‡] | 0.11 [‡] | -0.16 |
| Host country industry value-added (as % of GDP) | -7.85 | -1.76 | -6.22 | -2.15 | -10.54 | -6.03 | -0.40 | -4.23 |
| Host country service value-added (as % of GDP) | 10.32 | 15.54 | 8.97 | 14.92 | 5.59 | 9.29 [‡] | 0.83 [‡] | 0.72 |
| Constant | 24.99 ^{***} | 23.83 | -12.64 | 28.01 ^{**} | -20.35 | -16.84 | -7.03 | 21.53 [*] |
| R ² | 14.4 | 15.5 | 24.3 | 15.6 | 23.6 | 24.4 | 31.2 | 16.9 |
| Changes in R ² (vs Model 1) | - | 1.1 | 9.9 | 1.2 | 9.2 | 10.0 | 16.8 | 2.5 |
| N | 217 | 217 | 217 | 217 | 217 | 217 | 217 | 217 |

^a Figures represent unstandardised beta coefficients

Dependent variable = FDI per capita

† $p < .10$; * $p < .05$; ** $p < .01$; *** $p < .001$

DATA ANALYSIS

We tested our three hypotheses by first running a baseline model (Model 1 in Table 2) with the dependent variable and the control variables. Table 2 details the results of each of the models. Model 2 added the host country's rule of law independent variable, thus testing Hypothesis 1. Similarly, Model 3 tested Hypothesis 2, and Model 4 tested Hypothesis 3. Additional models, while not hypothesised, are included in Table 2 to clearly demonstrate the contribution of each of the independent variables to the overall model.

Table 2 presents the results of the regression analysis using unstandardised coefficients. The first hypothesis (Model 2) proposed that host countries with a higher rule of law would receive a greater share of FDI per capita. The regression for Model 2 was significant ($R^2 = 14.44\%$, $F_{9, 217} = 4.23$; $p < 0.001$). As evidenced in Table 2, there is a positive and somewhat significant relationship ($t = 1.64$; $p < 0.1$) between the host country's rule of law and levels of FDI per capita. Hypothesis 1 is supported, although the relationship is weak.

Model 3 specifically considered whether institutional differences in the home countries (Japan and South Korea) were significant in impacting the relationship between the host country's rule of law and FDI investment. Model 3 was also significant ($R^2 = 31.2\%$, $F_{11, 217} = 8.48$; $p < 0.001$), and the interaction between the host country's rule of law and home country's rule of law was positive and significant ($t = 4.53$; $p < 0.001$). Hypothesis 2 is supported, which is further evidenced by graphing the results (Figure 3).

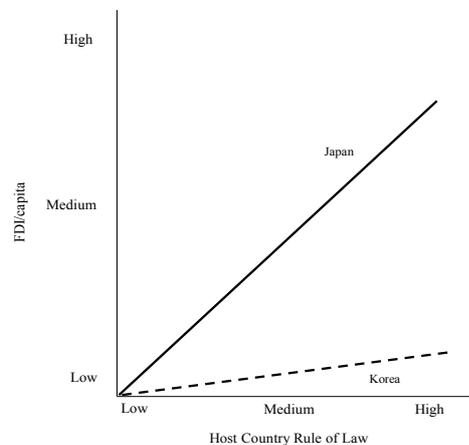


Figure 3. Impact of home country rule of law (Japan, South Korea) on the relationship between host country rule of law and outbound FDI per capita by the home country

Figure 3 demonstrates the finding that for Japanese investment in other countries, the higher the host country's rule of law, the higher the level of FDI invested by Japanese companies in the host country. Figure 3 demonstrates a similar result for Korea but at a lower intensity than that for Japan. Thus, the effect of the host country's rule of law on incoming FDI to that country is lower for Korea than it is for Japan.

The third hypothesis (Model 4) proposed that the relative difference between the rule of law in the home and host country would moderate the relationship between the host country's rule of law and the level of FDI per capita. Hypothesis 3 attempts to examine the effect of the situation where a host country could have a high rule of law, but it is still lower than that of the home country. This hypothesis required a segmentation of the data into two groups: the first group had a rule of law equal to or greater than that of the host country, and the second group had a rule of law that was lower than that of the host country. There was a significant difference between the two groups' FDI per capita; countries with a rule of law lower than that of the host country had a mean FDI per capita of 6.26 (standard deviation of 22.43), while countries with a rule of law higher than that of the host country had a mean FDI per capita of 25.93 (standard deviation of 55.40). This result is illustrated in Figure 4.

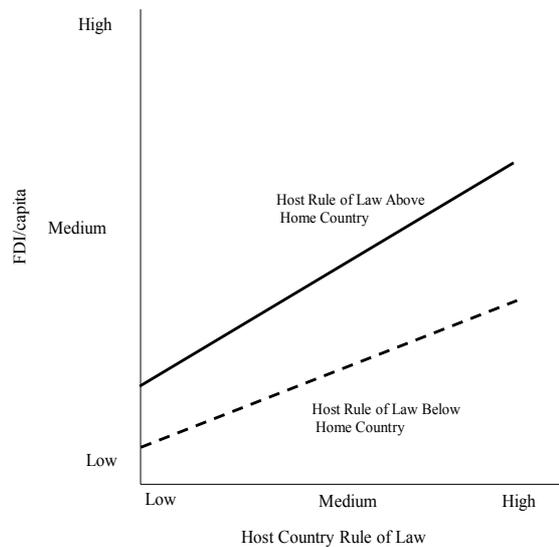


Figure 4. Impact of the relative host country rule of law (above or below that of the home country) on the relationship between the host country rule of law and outbound FDI per capita by the home country

Again, Model 4 was significant ($R^2 = 16.9\%$, $F_{11, 217} = 3.80$ $p < 0.001$). In addition, there was a positive and significant interaction between the relative rule of law and the rule of law in the host country ($t = 1.75$; $p < 0.05$), suggesting that the positioning of a host country's rule of law vis à vis the rule of law in the home country is important. Therefore, Hypothesis 3 is supported.

Based upon the significant results of these three hypotheses, we suggest that the rule of law in the host country, the legal institutional conditions of the home country itself, and, finally, the relative difference between the rule of law in the home and host country add additional predictive power for FDI per capita beyond that contributed only by the control variables of GDP per capita, government consumption, inflation, labour growth, cultural practices and values, and industry. This was evidenced through an R^2 increase in each of the models when measured against the baseline (Model 1), as presented in Table 2.

DISCUSSION

This research heeds the call of Henisz and Swaminathan (2008, p. 537) that "international business research necessarily requires attention to the institutional characteristics that alter the costs of engaging in business activity of a given form in one nation as compared to another." We add to the body of work that examines factors beyond the traditional, locational advantages of where, when and why firms invest in foreign countries. In so doing, we support the suggestion of Peng et al. (2008) that the institutional-view be observed as complimentary to the industry and resource-based views commonly used in international business literature. While our analysis supports previous research demonstrating that the higher a host country's rule of law index is, the higher the level of FDI per capita it will receive, we look beyond this base concept by demonstrating that it is both the institutional conditions in the home country and the relative nature of the rule of law between the home and host country that are relevant when trying to understand and attract FDI. In doing so, we clarify the relationship between the rule of law index of the host country and the legal institutional differences between the home country and the host country. We illustrate that the rule of law indices in the home and host countries should not be considered as operating in a vacuum but rather in conjunction with each other in relation to FDI.

We have also found some support for the influence of the institutional conditions of the home county on companies' FDI decisions. This study discovers that companies are comfortable investing in host countries with institutional characteristics similar to their own home country. While departing somewhat from the conventional wisdom that companies will only seek stability in foreign markets, we adopt an institutional theory approach, suggesting that a firm looking

to make an investment choice between two foreign countries will favour committing higher levels of FDI per capita to the country that has laws, governance systems, legal stability, and procedures that match (or exceed) those protections and expectations that would exist in the home country if it is based in a high rule of law country (e.g., Japan). However, if a firm is from a country exhibiting a medium rule of law rating (e.g., South Korea), our institutional theory approach suggests that firms in this country are comfortable investing in a host country with similar rules of law because they have experience with more flexible legal frameworks. By taking this more nuanced perspective, we incorporate the direct consideration of institutional conditions in the home country, particularly in terms of how they may influence an MNE's assessment of host jurisdictions. This may be positive news for countries with less stable institutional environments (i.e., those with a rule of law index similar to a medium rule of law index country) as they may find investors in countries that manifest similar institutional characteristics.

IMPLICATIONS

Our study results suggest that, based on the countries examined, the importance of the rule of law to FDI decisions may be influenced by the condition of institutions (the rule of law) in the home country itself. The two East Asian countries explored in this study, Japan and South Korea, have high and medium rule of law indices, respectively. In Japan, where the rule of law is high, our results suggest that a similarly strong rule of law in the host country is a potential factor for FDI per capita decisions. This may suggest that companies in a home country with a high rule of law index may consider their rule of law level to be a threshold for what they seek in institutional conditions in host countries.

In contrast, the rule of law appears to be less important to FDI decisions for companies in countries with mid-level rule of law indices, such as South Korea. This may be because South Korean businesses are used to operating with less certainty around legal conditions and so the institutional importance is decreased. These results suggest that the influence of the home country's institutional conditions may create fundamentally different approaches to FDI decisions. Host countries seeking investments from companies in high rule of law home countries may want to consider adopting measures that could increase their rule of law to become more attractive to companies based in these higher rule of law countries. If the host country already has a high rule of law index (such as Japan), it may be an advantage to them when the companies in the targeted home country have a similarly high level. Our preliminary research suggests that host countries with mid or low rule of law indices would do well to target companies in home

countries with mid-range rules of law, as these countries seem less influenced by strong host country institutional conditions when making FDI decisions.

Our research extends the utilisation of institutional theory into FDI decisions by looking at institutions at the country level. Biglaiser and Staats (2011) suggest that researchers might better focus on the institutions within democracies (rather than the presence of democracy itself) as a determinant of FDI, reinforcing the ongoing importance of institutions to international business study. We believe that while there has been much new conceptual development that has occurred that specifically considers an international context; the impact of home country institutional conditions on FDI decisions is a new perspective that adds to the current state of the research. Our research extends the work of scholars, such as Pajunen (2008) and Berry et al. (2010), who look at the importance of institutional factors in host countries but do not link it back to institutional conditions in the home country.

CONCLUSION

The rule of law is a construct that implicitly pervades almost every FDI decision made by companies all over the world. Firms question whether investments made in host countries will be protected from expropriation, whether their intellectual property will be protected, whether they will be dealt with fairly in disputes with local suppliers or customers, and whether they can expect stability in national institutions. These are not insignificant questions, and they are all encompassed within the consideration of the rule of law. This study lends initial support to the contention that while firms are investing in countries that have a higher rule of law, it is a relative relationship that is, to a certain degree, dependent on the institutional conditions in the home country. Therefore, countries looking to attract FDI may not need to strengthen their institutional systems to do so. This research suggests that they may just need to target their marketing approach to countries with similar institutional conditions.

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