# U.S. FDI and Shareholder Rights Protection in Developed and Developing Economies

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We examine the impact of shareholder rights protection on U.S multinational firms' Foreign Direct Investments (*FDI*). We hypothesize that the expropriation of wealth is less likely to occur in countries with strong shareholder rights and hence, these countries will attract more *FDI* relative to countries with weaker shareholder rights protection. We also hypothesize that this relationship will be more important for developing countries compared to developed countries. Based on an analysis of US *FDI* data over the period 1997-2016, we find support for our predictions. These findings emphasize the importance of institutional development for economic development, via the attraction of *FDI*. (JEL: F21, F23, G30, O16)

**Keywords:** *FDI*; expropriation; shareholder rights; multinational firms

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## I. Introduction

The diffusion of pro-market institutions, together with technology, has played a powerful role in shaping firm strategies, local economic development and global economic integration, especially since the 1980s (Cuervo-Cazurra et al., 2019). The implementation of these rules

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and regulations governing market-based transactions reduce direct government involvement in business (North, 1990), which in turn impacts domestic firm profitability (Park et al., 2006; Del Sol and Kogan, 2007; Cuervo-Cazurra, 2008). When economies transition by implementing pro-market institutions, they generally become more open and attractive to foreign investors (Henisz, 2000; Alimov, 2015). In countries whose governments tend to play a less direct role in economic development, foreign investments face fewer liabilities related to bribery, corruption, tax and trade discrimination and asset expropriation (Globerman and Shapiro, 2003; Awokuse and Yin, 2010).

Despite the substantial investigation into the impact of broad indices of pro-market reforms on domestic and international business strategies, there is relatively less research on specific institutions, such as shareholder rights protection. We conduct our study in the context of US outward foreign direct investments (*FDI*) worldwide, addressing an apparent paradox in research on *FDI*. Specifically, agency theory predicts that multinational enterprise (MNE) managers can use *FDI* as a means of 'escaping' more of the restrictive legal requirements of their home countries (Witt and Lewin, 2007; Barnard and Luiz, 2018). However, research has repeatedly shown that MNE managers' decisions are well aligned with the interests of shareholders, arguing that shareholder rights protection is particularly attractive to firms from that country, given that shareholder rights protection is rigorous at home. Based primarily on agency theory, we argue that although shareholder rights in a foreign country do not necessarily protect investors in the home or third country, they do result in lower monitoring costs which in turn induce favorable reactions from shareholders. Furthermore, bonding theory predicts that managers are compelled to act in accordance with shareholder interests out of a sense of obligation and identification (Hoskisson et al., 2009; Garcia-Cabrera and Garcia-Soto, 2012). While this may not be the case for outward *FDI* from all countries, corporations in the US are amongst the most rigorously aligned to the interests of shareholders (Glendening et al., 2016).

Using a sample of 64 unique developing and developed countries that received *FDI* from U.S multinational firms between 1997 to 2016, we find that the shareholder right index is positively related to inward *FDI* from U.S multinational firms. We also show that the protection of shareholders from expropriation is more important in developing countries compared to developed countries. This latter finding supports

our argument that institutional development is not only important. In general, but also more important for developing countries than developed countries, in attracting foreign *FDI*.

This paper contributes novel findings concerning MNEs regional strategies, specifically by providing an institutional view on market entry (Rugman and Verbeke, 2005; Arregle et al., 2013, 2016; Verbeke and Kano, 2016). It also contributes to *FDI* theory by adding a counterpoint to the generalized view that MNEs can overcome institutional voids via *FDI* (Buckley and Casson, 1998; Verbeke and Kano, 2012; Narula and Verbeke, 2015). We argue that MNEs are more, not less, exposed to political risk in host countries with weaker or absent shareholder rights protection. Our finding that *FDI* in developing economies is more attracted to countries with higher shareholder rights protection, relative to other countries within the region, supports this argument. Our finding that shareholder rights protection plays a much stronger role in developing, versus developed, countries suggests future research on institutional effects on *FDI* should consider the strength of institutions relative to a country peer group, such as a trading block or economically integrated region.

In the following section, we review the literature on *FDI* location choice and shareholder reactions to formulate our hypotheses concerning the impact of shareholder rights protection on *FDI* inflows. Following this, we describe our data and methodological approach. Next, we present the results of our hypothesis testing and discuss these within the context of existing literature. Finally, we conclude with a summary of our findings, contributions, and extensions.

## II. Literature Review and Hypotheses Development

### *A. Shareholder Rights Protection and FDI Attractiveness*

Several studies find that the strength of a host country's governance infrastructure is an important determinant in attracting *FDI*. For example, Globerman and Shapiro (2003) find that the legal system that protects property and individual rights, stable public institutions and government policies that favor free and open markets all have a positive impact on US foreign direct investments and argue that *FDI* will be attracted to regions characterized by more favorable governance

infrastructure. Investments in governance infrastructure not only attract capital but also create the conditions under which domestic multinational corporations emerge and invest abroad. Furthermore, Gani (2007) shows that governance indicators such as the rule of law, control of corruption, regulatory quality, government effectiveness, and political stability are positively correlated with *FDI*. Morrissey and Udomkerdmongkol (2012), defining governance as voice and accountability, political stability and absence of violence, regulatory quality, rule of law and control of corruption, find that total investments are greater in countries with good governance. However, the benefits of shareholder rights protection, which has not previously been studied as a determinant of *FDI* location, are not clearly linked to the benefits of the firm or its managers. We explore competing arguments for both positive and negative influences of shareholder rights protection on *FDI* location attractiveness, ultimately arguing that the positive impacts outweigh the negative, at least within the context of *FDI* from countries which themselves have stronger shareholder rights protection.

Denis et al. (2002) argued that global diversification represents a cost arising from the agency relationship that exists between managers and investors. According to agency theory, managers can increase their utility and status by growing the firm through international expansion (Jensen, 1986; Eisenhardt, 1989). As agents of the shareholders, charged with maximizing profitability, managers may use *FDI* as a means to evade restrictions on personal rent seeking, including expanding the size of the firm in order to justify increases to their salary, benefits, or even satisfy their hubris (Seth et al., 2002; Buckley and Strange, 2011). The managers of these firms may also use subsidiaries in countries with weak regulatory oversight to facilitate concealment and diversion (Desai, 2005). Lskavyan and Spatareanu (2011) furthermore argue that weak legal shareholder protection in host countries makes it more costly for parent company shareholders to monitor foreign subsidiary and hold managers accountable in the case of misconduct. Therefore, managerial autonomy and the scope for pursuing private benefits increases (Hope et al., 2011). By engaging in empire-building, they fail to place shareholders' interests at the core of strategic decision-making (Jensen and Meckling, 1976). Hence, a manager whose interests are not well aligned with shareholders would seek to avoid investing in a country with strong shareholder rights protection.

Although agency theory would predict that shareholder rights

protection would have a negative impact on the attraction of *FDI*, this argument loses its strength when the limited jurisdiction of shareholder rights protection laws is considered. That is, even where the board of directors provides strong oversight in representing shareholder interests, shareholder rights protection, in the host country, doesn't benefit shareholders in the MNE home country. Despite this, empirical research on *FDI*, from the field of international business, has repeatedly shown that MNE managers are much more likely to act in accordance with shareholder interests rather than their own. These observations are counter to the predictions of agency theory cited above, and so there is a paradox which might be explained by differences between the governance institutions studied and the owner-oriented focus of shareholder rights protection. First, the governance literature tends to focus on macro institutional governance mechanisms, such as political and legal institutions, as they relate to determinants of *FDI* (e.g. Globerman and Shapiro, 2002, 2003; Gani, 2007). Research on the *FDI* attractiveness of more micro, shareholder-oriented, governance mechanisms must take into account agency mechanism in addition to the transaction costs minimization rationale for international expansion (Buckley and Strange, 2011).

Another argument for the positive influence of shareholder rights protection on *FDI* attractiveness is that subsidiary managers and shareholder interests may be substantially aligned. 'Midrange' stakeholder theory predicts that the management practices of a local subsidiary will be more in line with the expectations of home country stakeholders when the institutional environments of the two countries are similar (Crilly, 2011). Hence, choosing a location with strong shareholder rights protection signals the foreign subsidiary's shareholder orientation, reducing agency costs for the overall MNE. MNE managers in the home country, who are already substantially aligned with the interests of their shareholders, will engage in less monitoring of the management of local subsidiaries in foreign countries with strong shareholder protection, reducing overall agency costs, and protecting their own stake in the company. Subsidiary-level stakeholder orientation is consistent with research showing that the global standards to which multinational corporations are held results in powerful incentives which align MNE management practices with the home country institutions (Le et al., 2013; Glendening et al., 2016; Mason et al., 2017).

In accordance with bonding theory, (Hoskisson et al., 2009;

Garcia-Cabrera and Garcia-Soto, 2012) managers making *FDI* decisions may be well-aligned with shareholders not only as a matter of financial benefits, but also sometimes out of a sense of accountability. Indeed, conformance with local practices by a foreign MNC is unlikely, especially when the host country's institutional environment is weak while that of the investor country is strong (Crilly, 2011). Similarly, bonding costs (Hoskisson et al., 2009) emerge because a CEO of a multinational firm may commit him/herself to contractual obligations that constrain his/her activities, resulting in reduced agency costs. Hence, managers of MNEs may legally and reputationally signal their willingness to limit expropriation from shareholders and reduce agency costs by investing in countries with strong shareholder rights protection.

Finally, although shareholder rights in the host country do not protect shareholder rights in the MNE home country, agency theorists have argued that it may have an indirect effect. According to agency theory, there exists a set of the most efficient shareholder rights protection, typically modeled after the Anglo-American model (Luo et al., 2009). Arguably, having effective shareholder rights protection reduces agency costs associated with the risk of expropriation, empire-building, and monitoring costs. Doukas and Lang (2003) argue that, since the operations of MNCs are geographically dispersed, difficulties in gathering and processing information make monitoring costlier in foreign subsidiaries than in parent firms. Hence, increased monitoring costs and other agency problems associated with foreign investments may discourage such *FDI*. As a result, managers can signal their intent to reduce agency costs by investment in countries with strong shareholder rights protection. Likewise, Coffee Jr (1998, 2002) and Stulz (1999) predict that MNEs' *FDI*, which are subjected to stringent investor protections, can constrain shareholder expropriation and hence, reduce agency costs. Furthermore, (Lien et al., 2005) argue that when there is an increase in information asymmetry between managers and owners/shareholders, that is related to the internationalization of the firm, the shareholders may use governance mechanisms to mitigate the associated agency costs. Hence, we predict:

> Hypothesis 1: There is a positive relationship between the strength of a country's shareholder rights protection, as indicated by the magnitude of the shareholder rights index and the amount of inward *FDI* received.

*B. Shareholder Rights in Developing Vs. Developed Countries*

The literature on *FDI* suggests that there are significant differences between developed and less developed countries in terms of both competitive and institutional environments (Makino et al., 2004; Mingo et al., 2018). Makino et al. (2004) argue that less developed countries have a greater potential for economic growth but weaker institutional support such as lower levels of property rights protection and enforcement mechanism compared to developed countries. Globerman and Shapiro (2003) show that improvements in governance infrastructure are important determinants of economic growth for developing and transition economies, alike. Similarly, good institutional quality is an important attractor of *FDI* (Buchanan et al. (2012). Hence, we argue that developing countries provide greater growth opportunities for U.S. MNEs, but their achievement is often hindered by institutional voids. Institutional voids refer to the lack of mechanisms that support economic liberalization and property rights and from the perspective of agency theory, increase information asymmetries between managers and owners of corporations (Contractor et al., 2014). *FDI* provides foreign investors with a way to control operations in a foreign country while overcoming political risk (Delios and Henisz, 2003). However, this suggests that MNEs face a choice between direct investment and avoiding a country altogether when considering political risk. Shareholder rights protection, however, protects a firm's invested assets, and so establishing wholly-owned subsidiaries or equity joint ventures increases the MNE's exposure to expropriation, where shareholder rights protection is weak or nonexistent. Desai and Moel (2008) show that despite an investor's 99% interest in the joint venture, the local partner managed to divert value from the underlying entity for personal benefits.

Hence, we argue that shareholder rights protection can bridge or eliminate institutional voids common in emerging markets (Clark and Tunaru, 2001; Wi Saeng et al., 2003; Khanna et al., 2005) that *FDI* alone cannot. Therefore, we expect that shareholder rights protection plays a greater role in attracting *FDI* to developing countries relative to developed countries, where the institutional environment is generally more developed and reliable. For example, Kinda (2010) shows that constraints related to investment climates such as infrastructure problems, financing constraints and institutional problems hamper *FDI*

in developing countries. Furthermore, Dollar et al. (2006) conclude that a better investment climate, in general, encourages *FDI*. Similarly, for a sample of developing countries, Sekkat and Veganzones Varoudakis (2007) show that countries having opened their economy were able to attract more *FDI*. The improvement in other aspects of the investment climate can result in an increase in *FDI* inflows that is even more important than the one resulting from greater openness.

We argue that shareholder rights protection is important in enhancing the investment climate, reducing agency problems and potentially reducing institutional voids in emerging economies. Therefore, we predict that:

> Hypothesis 2: The positive relationship between the strength of a country's shareholder rights protection, as indicated by the magnitude of the shareholder rights index and the amount of inward *FDI* received, is stronger in developing countries compared to developed countries.

## III. Data and Methodology

### *A. Data*

Our sample period is from 1997 to 2016. *FDI* data is capital expenditure by U.S multinational firms and it is collected from the Bureau of Economic Analysis. Our main variable of interest is the shareholder rights protection index constructed by Guillen and Capron (2016). They constructed an index of minority shareholder protection for 78 least-developed, emerging, and developed countries based on, for example, powers of the general meeting for de facto changes; agenda-setting power; prohibition of multiple voting rights; independent board members; feasibility of directors' dismissal, etc. Also, we extract GDP per capita, GDP growth to control for economic prospects, the total population from World Development Indicators, *FDI* stock from United Nations Conference on Trade and Development (UNCTAD), trade ratio using data from World Trade Organization (WTO), political constraint index and rule of law from the World Governance Indicators project (Kaufmann et al., 2008). We use the UN Human Development Index (HDI) to proxy for the quality of life and real exchange data is

from Bruegel.[1] We collect data on culture using Hofstede's indicators. Finally, we divide countries into developed and developing subsamples based on the United Nation's World Economic Situation and Prospects (WESP) 2019 report.

After merging all the data, we drop countries with missing data. Our final sample is a panel dataset with 1,208 country-year observations. This represents 64 unique developing and developed countries that received *FDI* from a U.S multinational firm from 1997 to 2016.

*B. Methodology*

We utilize a panel regression technique with year and country fixed effects to examine our hypotheses. We estimate the following regression:

$$\log FDI_{i,t} = \alpha + \beta \text{ShareRights}_{t,i} + \sum_{i=1}^{n} Y_i \text{Controls}_{i,t} + \varepsilon_{i,t} \qquad (1)$$

where log $FDI_{i,t}$ is the log transformation of total *FDI* by U.S multinational firms in country *i* and time *t*. Our main variable of interest is minority shareholder rights (ShareRight) index constructed by Guillen and Capron (2016). To construct a cross-national, comparative measure, Guillen and Capron (2016) collected information on the ten key legal provisions identified as most relevant to the protection of minority shareholder rights (Lele and Siems, 2007; Siems, 2008): powers of the general meeting for de facto changes; agenda-setting power; the anticipation of shareholder decision facilitated; prohibition of multiple voting rights; independent board members; feasibility of directors' dismissal; private enforcement of directors' duties (derivative suit); shareholder action against resolutions of the general meeting; mandatory bid; and disclosure of major share ownership. If present, each of these legal provisions provides minority shareholders with a comprehensive set of protections against the actions of large shareholders and/or management and in the event of a change in corporate control. See, Guillen and Capron (2016) for detailed information on the construction of the index.

Based on the existing empirical and theoretical literature, we control

1. Bruegel is a Brussels-based economic think tank (Darvas, 2012).

for several macroeconomic, political, institutional, and legal measures that have been proven to influence *FDI*. We include the gross domestic product (log of GDP) to account for market size and it is expected to be positive. Large market size is expected to attract *FDI* because of economies of scale in production and distribution for products (Globerman and Shapiro, 2003). Furthermore, market size may be associated with agglomeration economies that lower costs for all producers in that market (Krugman, 1991). Hence, we include *FDI* stock (log of *FDI*) as a proxy of agglomeration of economies. Furthermore, several studies show that political stability influences *FDI* flows (Levis, 1979; Root and Ahmed, 1979; Schneider and Frey, 1985; Wei, 1997). Hence, we utilized the political constraint index to measure political stability and rule of law to control political and legal risk. Also, we control for market competitiveness using GDP growth and population to measure the labor pool (Bailey, 2018).

Following Globerman and Shapiro (2003), we also include the HDI as a further control variable to account for several factors that have been shown to influence *FDI*.[2] The literature suggests that HDI is a valid proxy for the quality of life. Therefore, we expect that higher levels of HDI will attract more *FDI*.

The *FDI* literature suggests exchange rates may affect *FDI* flows and hence, we include real effective exchange rate as a control variable (Frühwirth et al., 2007). Several studies have documented a negative relationship between measures of foreign exchange volatility and *FDI* flows (Froot and Stein, 1991; Kogut and Chang, 1996; Barrell and Pain, 1997). Furthermore, Globerman and Shapiro (2003) argue that currency volatility is likely to discourage *FDI* of risk-averse investors. Since they view volatility as a direct or indirect cost. We expect real exchange rates to be negatively associated with *FDI* flows.

To control for cultural distance, we include the Hofstede cultural indicators (Mingo et al., 2018). Given that the cultural indicators are time-invariant, we include them in a panel regression framework without country fixed effects.[3]

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2. Given that the Human Development Index (HDI) is relatively correlated with the rule of law, we estimate the model with both and with rule of law only and the results are similar. HDI is derived from three sub-indices: GDP/population, educational literacy and enrolment, and life expectancy at birth.

3. We use a Random Effect Generalized Least Square technique.

## IV. Results

### *A. Descriptive Statistics*

In table 1, panel A, we report the summary statistics for the entire sample. The average *FDI* in the sample is $2.18b (median is $711mil). In terms of shareholder rights protection index, the mean is 5.30 (median is 5.50). In addition, mean (median) human development index is 0.57 (0.55). In terms of a proxy for the labor pool (population) in a country, the average is 80.50m with a median of 23.77m individuals. The average *FDI* stock in the sample is $174.7b with a median of $65.4b. The average market size (GDP) is $600b (median is $210.7b) while the mean GDP growth is 3.38%. We control for openness to foreign investment of an economy using the trade ratio. The mean (median) trade ratio is 72.3% (57%). In terms of legal and political risk, the mean rule of law and political stability (political constraint index) for the entire sample is 0.48 and 0.39, respectively. Finally, the averages for Hofstede's culture indicators are power distance (60.34), individualism (42.38), masculinity (47.42) and uncertainty avoidance (65.93).

In panel B, we present descriptive statistics for developed and developing countries as well as the tests for differences in mean (t-test) and median (Wilcoxon rank-sum test). Developed countries tend to attract more *FDI* from U.S multinational firms, have larger GDP, GDP per capita, *FDI* stock, higher HDI, rule of law and political constraints index scores compared to developing countries. On the other hand, developing countries tend to have a larger population, higher GDP growth rate and higher power distance relative to developed countries in our sample. In terms of openness of the economy, developed countries are not different from developing countries (71.65% vs. 72.79%). We find similar results for masculinity and uncertainty avoidance whereas developed countries have a higher score for individualism (mean of 58.32) compared to developing countries (mean of 28.04).

In table 2, we report the correlation matrix of the variables used in our model. The correlation is relatively what is expected. However, the rule of law and human development index are relatively correlated. In our estimation model, we only include rule of law in one specification and then both in a second specification and the results are quantitatively similar. Hence, our concerns with multicollinearity are alleviated.

**TABLE 1. Descriptive Statistics**

A. Entire Sample

| | Mean | Median | St. Dev. | Obs. |
|---|---|---|---|---|
| *FDI* (mil) | 2,178.6880 | 711.0000 | 4,121.7310 | 1208 |
| Shareholder Rights | 5.2992 | 5.5000 | 1.4586 | 1208 |
| Real effective exchange rate | 101.5698 | 100.0000 | 18.7542 | 1208 |
| Human development index (HDI) | 0.5686 | 0.5500 | 0.1678 | 1208 |
| Population (mil) | 80.5008 | 23.7749 | 220.8531 | 1208 |
| *FDI* stock (mil) | 174,739 | 65,375 | 265,328 | 1208 |
| GDP (mil) | 600,051 | 210,676 | 1,123,277 | 1208 |
| GDP per capita | 18,917 | 10,463 | 20,700 | 1208 |
| GDP growth rate % | 3.3777 | 3.3752 | 3.5624 | 1208 |
| Trade ratio % | 72.2700 | 56.9800 | 54.4200 | 1208 |
| Rule of law | 0.4756 | 0.4600 | 1.0309 | 1208 |
| Political constraint index | 0.3946 | 0.4362 | 0.1770 | 1208 |
| Power distance | 60.3437 | 64.0000 | 20.8008 | 1123 |
| Individualism | 42.3847 | 35.0000 | 23.6759 | 1123 |
| Masculinity | 47.4212 | 50.0000 | 18.8654 | 1123 |
| Uncertainty avoidance | 65.9323 | 70.0000 | 22.5746 | 1123 |
| Political Risk Index (PRS) | 73.7323 | 73.8801 | 9.0709 | 1208 |

**Note:** *FDI* is foreign direct investment from US multinational firms. Shareholder Rights is the Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. Political Risk Index (PRS) measures political and country risk.

### *B. Regression Results*

In table 3, we present the panel regression results with and without country and year fixed effects. The results support our hypothesis 1 that higher minority shareholder rights protection leads to an increase in *FDI* by U.S multinational firms. In column I, we did not include HDI given that it is correlated with rule of law. We find that the shareholder rights index is statistically significant at the 1% level. This implies that U.S multinationals are more likely to invest in countries where expropriation of shareholders' wealth is less likely and governance mechanisms are in place that mitigate agency costs. Hence, hypothesis 1 is strongly supported. Our findings are consistent with the agency theory arguments forwarded by Lien et al. (2005). Similarly, our findings are in line with the bonding costs theory of Hoskisson et al. (2009) that CEOs of MNEs

**TABLE 1. (Continued)**

B. Developed Vs. Developing Sub-sample

| | Developed | | | | Developing | | | | Tests for difference | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mean | Median | St. Dev. | Obs. | Mean | Median | St. Dev. | Obs. | Mean | Median |
| *FDI* | 3,389 | 1,435 | 5,541 | 571 | 1,167 | 458 | 1,819 | 637 | 8.04*** | 6.57*** |
| Shareholder Rights | 5.6942 | 6.0000 | 1.3195 | 571 | 4.9690 | 5.2500 | 1.4879 | 637 | 6.29*** | 6.01*** |
| Real effective exchange rate | 97.4288 | 98.0150 | 10.8959 | 571 | 105.0311 | 102.1200 | 22.8166 | 637 | –8.66*** | –9.75*** |
| Human development index | 0.7121 | 0.7200 | 0.1030 | 571 | 0.4487 | 0.4600 | 0.1060 | 637 | 41.29*** | 27.57*** |
| Population (mil) | 27.6327 | 10.8773 | 30.6469 | 571 | 124.6915 | 34.9678 | 290.7370 | 637 | –8.29*** | –9.08*** |
| *FDI* stock (mil) | 264,286 | 147,018 | 295,988 | 571 | 99,890 | 28,007 | 209,287 | 637 | 8.41*** | 12.13*** |
| GDP (mil) | 849,208 | 379,960 | 1,127,216 | 571 | 391,789 | 108,628 | 1,077,429 | 637 | 6.49*** | 10.99*** |
| GDP per capita | 34,402 | 30,744 | 20,732 | 571 | 5,975 | 3,506 | 7,720 | 637 | 27.08*** | 25.12*** |
| GDP growth rate % | 2.4068 | 2.4839 | 2.7499 | 571 | 4.1891 | 4.3593 | 3.9429 | 637 | –9.61*** | –11.39*** |
| Trade ratio % | 71.6500 | 55.8700 | 52.3300 | 571 | 72.7900 | 59.1200 | 56.1500 | 637 | –3.48*** | –0.34 |
| Rule of law | 1.4118 | 1.5450 | 0.5099 | 571 | (0.3068) | (0.4300) | 0.6233 | 637 | 44.07*** | 27.53*** |
| Political constraint index | 0.4624 | 0.4862 | 0.1282 | 571 | 0.3378 | 0.3910 | 0.1917 | 637 | 19.25*** | 16.46*** |
| Power distance | 47.1184 | 50.0000 | 17.4604 | 520 | 72.2487 | 70.0000 | 15.7718 | 603 | –29.73*** | –23.45*** |
| Individualism | 58.3177 | 63.0000 | 21.3691 | 520 | 28.0423 | 25.0000 | 14.8343 | 603 | 34.08*** | 23.73*** |
| Masculinity | 46.7481 | 50.0000 | 22.2979 | 520 | 48.0271 | 49.0000 | 15.1183 | 603 | –5.67*** | –3.90*** |
| Uncertainty avoidance | 66.8102 | 70.0000 | 24.3653 | 520 | 65.1421 | 65.0000 | 20.8209 | 603 | 5.01*** | 4.52*** |

**Note:** Developed vs. developing countries are defined based on the United Nation's World Economic Situation and Prospects (WESP) 2019 report. *FDI* is foreign direct investment from US multinational firms. Shareholder Rights is the Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. Political Risk Index (PRS) measures political and country risk. The test of mean difference is the t-test while the test for difference in the median is the Wilcoxon rank-sum test. ***, **, * represents 1%, 5% and 10% significance levels, respectively.

**TABLE 2. Correlation Matrix**

| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | *FDI* | 1.0000 | | | | | | | | |
| 2 | Shareholder rights | 0.2937 | 1.0000 | | | | | | | |
| 3 | Real effective exchange rate | –0.0440 | –0.0141 | 1.0000 | | | | | | |
| 4 | Human development index | 0.3380 | 0.3497 | –0.1077 | 1.0000 | | | | | |
| 5 | GDP per capita | 0.3006 | 0.2328 | –0.0009 | 0.8058 | 1.0000 | | | | |
| 6 | GDP growth | –0.0781 | –0.0324 | –0.0515 | –0.2969 | –0.2504 | 1.0000 | | | |
| 7 | Trade ratio | –0.1118 | 0.1170 | 0.0271 | 0.1338 | 0.1473 | 0.0838 | 1.0000 | | |
| 8 | Rule of law | 0.2972 | 0.1603 | –0.1305 | 0.8149 | 0.7672 | –0.2114 | 0.2087 | 1.0000 | |
| 9 | Political constraint index | 0.0618 | –0.0056 | –0.1207 | 0.3421 | 0.2669 | –0.2032 | –0.0786 | 0.3531 | 1.0000 |
| 10 | GDP | 0.4820 | 0.3325 | 0.0997 | 0.2460 | 0.2099 | –0.0515 | –0.2041 | 0.1637 | 0.0371 |
| 11 | Population | 0.1044 | 0.1297 | 0.0497 | –0.2674 | –0.1939 | 0.2391 | –0.1815 | –0.1971 | –0.1287 |
| 12 | *FDI* Stock | 0.6423 | 0.3301 | 0.0381 | 0.4551 | 0.4728 | –0.1328 | 0.2485 | 0.4047 | 0.1010 |
| 13 | Power distance | –0.2275 | –0.0277 | 0.0699 | –0.6098 | –0.5789 | 0.2197 | 0.1513 | –0.6992 | –0.3963 |
| 14 | Individualism | 0.4175 | 0.2358 | –0.1549 | 0.6366 | 0.5980 | –0.2227 | –0.1217 | 0.6871 | 0.4761 |
| 15 | Masculinity | 0.1992 | 0.1874 | 0.1406 | –0.1129 | –0.0345 | –0.0111 | –0.1325 | –0.1569 | –0.1462 |
| 16 | Uncertainty avoidance | –0.2092 | –0.0193 | –0.0934 | 0.0219 | –0.1731 | –0.1560 | –0.3412 | –0.1968 | 0.1123 |
| 17 | Political Risk Index (PRS) | 0.2632 | 0.1824 | –0.0807 | 0.7123 | 0.7149 | –0.0007 | 0.2733 | 0.8234 | 0.2287 |

( *Continued* )

**TABLE 2. (Continued)**

| | | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 |
|---|---|---|---|---|---|---|---|---|---|
| 10 | GDP | 1.0000 | | | | | | | |
| 11 | Population | 0.4744 | 1.0000 | | | | | | |
| 12 | *FDI* Stock | 0.5465 | 0.1344 | 1.0000 | | | | | |
| 13 | Power distance | –0.0643 | 0.2220 | –0.1811 | 1.0000 | | | | |
| 14 | Individualism | 0.2032 | –0.1153 | 0.3699 | –0.6915 | 1.0000 | | | |
| 15 | Masculinity | 0.3646 | 0.1985 | 0.1796 | 0.1412 | –0.0142 | 1.0000 | | |
| 16 | Uncertainty avoidance | –0.0319 | –0.2449 | –0.2450 | 0.1701 | –0.1993 | 0.0240 | 1.0000 | |
| 17 | Political Risk Index (PRS) | 0.1910 | –0.1141 | 0.3336 | –0.5220 | 0.5319 | –0.1045 | –0.2086 | 1.0000 |

**Note:** *FDI* is foreign direct investment from US multinational firms. Shareholder Rights is the Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. Political Risk Index (PRS) measures political and country risk.

**TABLE 3. Panel Regression for Minority Shareholder Index on U.S. MNE *FDI***

| | FE | FE | REGLS |
|---|---|---|---|
| | I | II | III |
| ShareRights | 0.1033*** | 0.1058*** | 0.0677*** |
| | (3.93) | (4.07) | (2.74) |
| Log (GDP) | 0.8523*** | 0.9073*** | 0.8511*** |
| | (11.05) | (11.79) | (11.60) |
| Log (*FDI* stock) | 0.3808*** | 0.4024*** | 0.4425*** |
| | (9.73) | (10.34) | (10.55) |
| GDP Growth | 0.0031 | 0.0067 | 0.0058 |
| | (0.64) | (1.38) | (1.22) |
| Trade Ratio | –0.0047 | –0.0569 | –0.0692 |
| | (–0.05) | (–0.57) | (–0.72) |
| Rule of law | –0.0032 | –0.0609 | –0.0303 |
| | (–0.04) | (–0.68) | (–0.35) |
| Political constraint index | –0.3986*** | –0.3971*** | –0.2441** |
| | (–3.28) | (–3.31) | (–2.09) |
| Log (population) | 0.1917 | 0.2942 | 0.1062 |
| | (0.95) | (1.47) | (1.00) |
| Real effective exchange rate | –0.0045*** | –0.0053*** | –0.0049*** |
| | (–4.64) | (–5.43) | (–5.84) |
| Human development index | | 3.0977*** | 2.4102*** |
| | | (5.21) | (4.42) |
| Power distance | | | –0.0051 |
| | | | (–0.49) |
| Individualism | | | –0.0248*** |
| | | | (–2.77) |
| Masculinity | | | –0.0051 |
| | | | (–0.63) |
| Uncertainty Avoidance | | | –0.0067 |
| | | | (–1.01) |
| Intercept | –8.1370*** | –10.7020*** | –7.5179*** |
| | (–9.28) | (–10.74) | (–6.44) |
| Year fixed effects | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | No |
| N | 1,208 | 1,208 | 1,123 |
| Adj. $R^2$ | 45.1% | 46.3% | 53.3% |

**Note:** The dependent variable is log (*FDI*) where *FDI* is foreign direct investment for US multinational firms. Shareholder Rights is the Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. The t-statistics are reported below the estimated coefficients in parentheses. ***, **, * represents 1%, 5% and 10% significance levels, respectively.

may bond themselves to actions such as investing in a strong shareholder protection environment to reduce agency costs associated with international diversification. Furthermore, our findings that countries with strong shareholder rights protection attract a greater amount of U.S MNEs *FDI* supports the argument that a formal corporate governance structure that protects shareholders reduces the classic agency costs and hence, encourages managers in countries with strong shareholder rights to act in the interests of their shareholders (Kuipers et al., 2009).

In terms of control variables, market size (GDP) and *FDI* stock are positively influencing additional *FDI*. Furthermore, higher political risk, as well as higher real effective exchange rates result in lower *FDI*. Other control variables such as GDP growth, trade ratio, rule of law, and labor force appears to be insignificant in our sample. Following Globerman and Shapiro (2003), we include the human development index (in column II) as an additional control variable. HDI is derived from three sub-indices: GDP/population, educational literacy and enrolment, and life expectancy at birth. Globerman and Shapiro (2003), argue that health and education components are direct measures of human capital. The GDP per capita component is a measure of wealth that has traditionally been used to measure consumer demand but it may also serve as a proxy measure for physical infrastructure. We include the log of GDP and GDP growth rate which is also a measure of wealth and consumer demand. The correlation between HDI and GDP is 0.25 while it is -0.30 with GDP growth. The results are quantitatively like those in column I. HDI is positive and significant at the 1% level.

In column III, we control for Hofstede's cultural indicators, to account for psychological distances between the US and the *FDI* locations. Our results remain the same with the addition of these control variables. All the cultural indicators are negatively related to *FDI* but statistically insignificant except for individualism.

To test hypothesis 2, we divided our sample into developed countries and developing countries based on the United Nation's World Economic Situation and Prospects (WESP) 2019 report. This resulted in 52.74% of the countries in our sample to be classified as developing while 47.26% are classified as developed countries. We report the results for sub-sample analyses in table 4. As hypothesized, we find that the protection of shareholder rights is more important in developing countries compared to developed countries. Our shareholder rights protection index is positive and statistically significant at the 1% level.

**TABLE 4. Developing Vs. Developed Countries**

| | Developing | Developed |
|---|---|---|
| ShareRights | 0.2234*** | 0.0025 |
| | (5.46) | (0.08) |
| Log (GDP) | 1.0833*** | 1.1784*** |
| | (9.78) | (5.80) |
| Log (*FDI* stock) | 0.5038*** | 0.3063*** |
| | (8.19) | (6.40) |
| GDP growth | 0.0053 | 0.0036 |
| | (1.06) | (0.46) |
| Trade ratio | –0.0176 | –0.0677 |
| | (–0.14) | (–0.31) |
| Rule of law | –0.0755 | –0.3051* |
| | (–0.64) | (–1.91) |
| Political constraint index | –0.4779*** | 0.0952 |
| | (–3.25) | (0.37) |
| Log (population) | 0.3067 | 0.8021 |
| | (1.16) | (1.60) |
| Real effective exchange rate | –0.0062*** | –0.0099*** |
| | (–5.31) | (–2.75) |
| Human development index | 2.2483** | 2.2273*** |
| | (2.25) | (2.90) |
| Intercept | –13.1157*** | –13.3077*** |
| | (–8.99) | (–5.56) |
| Year fixed effects | Yes | Yes |
| Country fixed effects | Yes | Yes |
| N | 637 | 571 |
| Adj. $R^2$ | 50.7% | 41.9% |

**Note:** Developed vs. developing countries are defined based on the United Nation's World Economic Situation and Prospects (WESP) 2019 report. The dependent variable is log (*FDI*) where *FDI* is foreign direct investment for US multinational firms. Shareholder Rights is the Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. The t-statistics are reported below the estimated coefficients in parentheses. ***, **, * represents 1%, 5% and 10% significance levels, respectively.

This implies that in countries with growth opportunities where expropriation of shareholders' wealth is more likely to occur, the protection of shareholder rights is an important factor in attracting *FDI* from U.S multinational firms. Our results are consistent with prior studies (Makino et al., 2004; Sekkat and Veganzones Varoudakis, 2007;

Kinda, 2010) that better investment climate as well as reducing institutional voids encourage *FDI*. Furthermore, our findings that strong shareholder rights protection in developing countries is an important determinant of U.S MNEs *FDI* supports the conjecture by Desai and Moel (2008) that multinational firms are likely to benefit from stronger investor protection compared to local firms. In terms of control variables, market size, *FDI* stock, political risk, real exchange rate and HDI are like those reported in table 3.

In terms of developed countries, the protection of shareholder rights index is positive but statistically insignificant in our sample (table 4, column II). This suggests that expropriation risk is lower in developed countries and hence, protection of shareholders' rights appears to be less important relative to developing countries as a determinant of *FDI*. One potential explanation is that the judicial and legal recourse in the event of expropriation of shareholders is enough to attract *FDI* from U.S multinational firms. Also, developed countries tend to have bilateral or multilateral trade agreements that may further alleviate the risk of potential expropriation.

### *C. Robustness Check*

We conducted several robustness checks. First, to ensure that our results are robust, we group-demeaned shareholder rights protection index and the *FDI*, defining the groups by geographic region, and re-run our analysis. This was done because while our main fixed effect model essentially eliminates the effect of unobserved heterogeneity amongst countries, there may also be unobserved heterogeneity between regions. Specifically, due to regional economic integration amongst countries, inward *FDI* to a focal country may be partially determined by shareholder rights protection, relative to regional member countries. Also, different regions generally attract different levels of inward *FDI* for non-institutional factors, such as resource endowments and comparative advantages. The results, which are like those presented in table 3, are shown in table 5. Second, La Porta et al. (1997) show that countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets and hence may attract less *FDI*. Therefore, following Globerman and Shapiro (2003) we include civil and common as additional control variables using the University of Ottawa Faculty of Law taxonomy. They classify legal systems into pure common law

**TABLE 5. Demeaned Shareholder Index on U.S. MNE *FDI***

| | FE | FE | REGLS |
|---|---|---|---|
| | I | II | III |
| Demeaned ShareRights | 0.1033*** | 0.1058*** | 0.0751*** |
| | (3.93) | (4.07) | (2.98) |
| Log (GDP) | 0.8523*** | 0.9073*** | 0.7722*** |
| | (11.05) | (11.79) | (10.38) |
| Log (*FDI* stock) | 0.3808*** | 0.4024*** | 0.4379*** |
| | (9.73) | (10.34) | (10.25) |
| GDP Growth | 0.0031 | 0.0067 | 0.0062 |
| | (0.64) | (1.38) | (1.26) |
| Trade Ratio | –0.0047 | –0.0569 | –0.1133 |
| | (–0.05) | (–0.57) | (–1.16) |
| Rule of law | –0.0033 | –0.0609 | –0.0479 |
| | (–0.04) | (–0.68) | (–0.54) |
| Political constraint index | –0.3986*** | –0.3971*** | –0.2469** |
| | (–3.28) | (–3.31) | (–2.08) |
| Log (population) | 0.1917 | 0.2942 | 0.0173 |
| | (0.95) | (1.47) | (0.16) |
| Real effective exchange rate | –0.0045*** | –0.0053*** | –0.0047*** |
| | (–4.64) | (–5.43) | (–5.05) |
| Human development index | | 3.0974*** | 1.5820*** |
| | | (5.21) | (2.86) |
| Power distance | | | –0.0050 |
| | | | (–0.50) |
| Individualism | | | –0.0261*** |
| | | | (–2.96) |
| Masculinity | | | –0.0059 |
| | | | (–0.75) |
| Uncertainty Avoidance | | | 0.0014 |
| | | | (0.21) |
| Intercept | –13.7893*** | –16.3411*** | –12.1970*** |
| | (–15.92) | (–16.57) | (–10.50) |
| Year fixed effects | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | No |
| Obs. | 1,208 | 1,208 | 1,123 |
| Adj. $R^2$ | 45.1% | 46.3% | 48.7% |

**Note:** The dependent variable is group-demeaned log (*FDI*) where *FDI* is foreign direct investment for US multinational firms. The group is defined by geographic regions. Demeaned ShareRights is the group-demeaned Guillen and Capron (2016) cross-national comparative legal measure of shareholder protection. *FDI* stock is total *FDI*. Trade ratio is defined as (export + import)/GDP. Political constraint index measures political risk. Power distance, individualism, masculinity and uncertainty avoidance is the Hofstede's cultural dimensions. The t-statistics are reported below the estimated coefficients in parentheses. ***, **, * represents 1%, 5% and 10% significance levels, respectively.

systems (COMLAW1) which are based primarily on English common law, mixed common law systems (COMLAW2) which is a blend of English common law with elements of customary or religious (usually Muslim) law, pure civil law (CIVLAW1) systems which are based on the Roman system and Mixed civil law (CIVLAW2) systems which combine elements of civil law with customary or religious law. There are also mixed systems of Muslim law, and customary law as well as civil and common law (defined as other). Similar to Globerman and Shapiro (2003), the common law legal system is marginally significant (10% level) in explaining *FDI* while civil is insignificant.[4] Third, we include the Political Risk Index (PRS) rating for political and country risk.[5] This measure is highly correlated with the rule of law. Therefore, we drop the rule of law as a control variable and include PRS rating instead. The results are similar to those reported in table 3.[6] Fourth, we re-define our dependent variable as US Multinational *FDI*/Total GDP. The results are similar to those presented in table 3.[7]

## V. Discussion and Conclusion

This paper contributes to the literature on *FDI* location attractiveness (e.g. Dunning, 1998; Buckley et al., 2007; Contractor et al., 2014) and to the application of agency and bonding theories in explaining the role of shareholder rights protection when MNE managers decide to expand via *FDI* (Lien et al., 2005; Hoskisson et al., 2009; Mason et al., 2017). First, we demonstrate that shareholder rights protection has a positive relationship with *FDI* flows even though international expansion allows managers to 'escape' more restrictive institutional environments in the U.S. or elsewhere (e.g. Witt and Lewin, 2007; Barnard and Luiz, 2018). Second, we contribute to bonding theory, which builds upon the basic premises of agency theory (Hoskisson et al., 2009), showing support for the premise that managers exhibit behavior more aligned with

4. Results are not tabulated and available upon request.

5. PRS Group uses a quant-driven approach to measure political risk and provides a political risk index.

6. Results are not tabulated and available upon request.

7. We would like to thank the referee for this suggestion. Results are not tabulated and available upon request.

shareholders' interests when making international expansion decisions.

The observed impact of shareholder risk on inward *FDI* provides a somewhat unique perspective on location attractiveness and regionalization. First, the logic of a dominant *FDI* theory in international business research, internalization theory (Buckley and Casson, 1998; Buckley et al., 2018), essentially leaves MNEs with a choice between internalizing transactions (i.e. engage in *FDI*) or avoiding countries with weaker institutions altogether (Delios and Henisz, 2003). However, we have argued that weak shareholder rights protection is not only unattractive to foreign investment but also that making capital investments increases, rather than decreases, the exposure of a firm to the risk of expropriation. In other words, *FDI* does not mitigate the risks of expropriation inherent in countries with weak shareholder rights protection, but rather aggravates the risk. Prior studies have shown that country risk, operationalized through broad indices, encourages internalization (Feinberg and Gupta, 2009). Our finding that MNE investment gravitates towards countries with higher shareholder rights protection suggests that not all risks are the same when it comes to entry mode and thus disaggregation of political risk is warranted in studies of both location choice and entry modes. It would be useful to re-categorize dimensions of political risk in which capital investment increases risk exposure and those in which investment reduces exposure. This would help to reduce the paradoxical relationship between the location unattractiveness of political risk and the choice to internalize transaction in response (Giambona et al., 2017).

Institutional similarities within region and differences between regions are salient predictors of MNEs' investment and strategizing patterns leading to regionalization. Our findings suggest that future research considering the cross-level effects of institutional differences within regions is warranted. Specifically, ranking a country's shareholder rights protection, relative to other members within the region, may better predict *FDI* than the absolute stringency of rights protection alone. Put another way, a country with moderate shareholder rights protection within a low-rights protection region will attract an equivalent share of regional *FDI* as a high shareholder rights country in a moderate rights protection region. This would have practical implications for host country governments and is also a worthy consideration for transnational NGOs using MNE's as trendsetters for global institutional standards adoption (Brandl et al., 2019).

Prior research, mainly from the field of economics, has explored the

phenomenon of countries within regions acting as platforms from which to serve an integrated region (Azemar and Desbordes, 2010; Cardamone and Scoppola, 2015; Ghosh et al., 2018; Ghosh and Yamarik, 2019). Considering how the relative standing of a developing country's pro-market institutions impacts foreign direct investment, in comparison to that of developed countries, it is important to policymakers and researchers who might otherwise consider institutional quality using a global lens. That is, while institutional quality may have an overarching main effect on *FDI* attractiveness, it likely also has a within-region effect. Failure to simultaneously consider the within-region and between-country effects of institutional reform can lead to model misspecification and also reveals an opportunity for developing multilevel theory in *FDI* research (Lien and Filatotchev, 2015). Hence, we further examine the impact of shareholder rights protection on *FDI* attractiveness between developed and developing countries. Hence, the study of shareholder rights protection and *FDI* offers a new context in which to possibly extend the export platform concept, namely, that more stringent institutional environments act as regional attractors, offering the potential for spillover effects. Future research could examine the role of regional institutional hubs in setting regional standards for *FDI* regulation and how institutions interact with factor conditions in attracting *FDI* within specific sectors. Considering these cross-level effects between country characteristics and regional development furthermore offers a novel insight into evolving economic geography.

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