

# Is FDI Doing Good? A Golden Rule for FDI Ethics<sup>\*†</sup>

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## Abstract

Ethical and economic perspectives on foreign direct investment (FDI) often appear in opposing frameworks. To combat this antagonism, this research proposes a consolidation between foreign private wealth and general welfare in host countries. The first contribution of this study is to provide a comprehensive conceptual approach to the study of FDI ethics. The second key contribution is to present empirical analysis of the differential influence of the level of democratic rights on foreign employment, new projects, and FDI capital flows. Results suggest that FDI incentivizes general welfare in least developed countries with high degrees of volatility. Additionally, policymakers face a dilemma in which democracy and legal rights seem to be mutually incompatible with fostering foreign employment. Practitioners find a way to evaluate the ethical implications of international business activities. The study analyzes FDI data from 161 countries between 2003 and 2010 by means of the FDI gravity equation.

**Keywords:** Ethics; international business; foreign direct investment; gravity equation; democracy; legal rights; employment.

**JEL Classification:** F20, F21, F23.

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# 1 Introduction

The tension between profitable business and ethics comes to a head in the most persistent and labor intensive form of international business: foreign direct investment (FDI). While ethical responsibility advocates expansive public policy to strengthen stakeholder rights, economic responsibility advocates market wealth creation (Windsor 2006). FDI is not just an exchange of goods and services, but also a profound form of human relations across country borders. Foreign companies bring wealth, employment, knowledge, business projects, and corporate values to a host country. FDI exerts influence on the economic, social, and political spheres of the recipient country (Blomström and Kokko 1996). International corporations therefore have an economic and ethical responsibility, starting in the country of origin and extending to the host nation.

International business ethics (IBE) is a broad construct that deals with business ethics in an international context (De George 1994; Robertson and Athanassiou 2009; Warren 2011). FDI ethics focuses on the differential characteristics of FDI within IBE, which itself underlies and is inseparable from the general ethics of the social order (Homman 2008). Researchers define FDI ethics as the process of reaching a moral order (i.e., doing good) in a foreign market (Bardy, Drew, and Kennedy 2012; Doh, Husted, Matten, and Santoro 2010; Stanley 1990).

Despite the social and economic interest in IBE, scholars fail to explore fully several questions to do with FDI. For example, is FDI doing good to the general welfare of host countries; does the degree of democracy and legal rights foster new investment partners and employment; and what is the role of the economic development of host countries? As a result, companies and policymakers often find themselves on ethical quicksand, undertaking business decisions and implementing policies without a clear understanding of the ethical context of their actions.

Unlike the vast body of extant literature on IBE, little research exists on FDI ethics (Egri and Ralston 2008). For example, few empirical studies delve into the effect of the degree of democracy in least developed countries (LDC) on the level of FDI inflows (e.g., Agosin and Machado 2005; Li and Resnick 2003; Mathur and Singh 2013; Moran, Graham, and Blomström 2005; Siegel, Licht, and Schwartz 2013). Scholars have yet to examine the dynamic effect of democracy and legal rights on FDI types (i.e., capital, employment, and new projects) in LDC and more developed countries (MDC).

The ongoing global recession brings FDI in MDC to the spotlight, shifting the focus of IBE from south to north. While FDI flows to developed economies fall, FDI is surging in structurally weak economies (UNCTAD 2013). As a result of global credit constraints, multinational enterprises are more selective in their international endeavors (Gil-Pareja, Llorca-Vivero, and Paniagua 2013). Consequently, the competition between MDC to attract a diminishing number of international projects is intense. Consider, for example, Spain. Struck with unemployment rates of 25%, the authorities rush to make ad hoc changes to local labor, tax, gambling, and health regulations, to attract the €6 billion, 260,000-job Eurovegas investment project (The Economist 2012).

The contributions of this paper are the following: first, this research conceptualizes FDI ethics. The golden rule, do as you would be done by, an ethical common ground for different cultures and religions (Küng 1997), inspires the conceptual framework of this paper. Second, this research employs a gravity model for the empirical framework. The gravity equation is one of the most successful empirical tools in international economics, with a sound theoretical foundation (Bergstrand and Egger 2011). Third, this study measures the influence of legal rights and democracy on foreign employment, projects, and capital flows in a set of 30 LDC and 131 MDC. Additionally, this research is, apparently, the first to incorporate employment

data of foreign subsidiaries in the gravity equation.

The remainder of the paper has the following structure. Section 2 briefly analyzes the existing literature to build a conceptual model. Section 3 sets out the empirical model and provides some stylized facts about the data. Section 4 discusses the results, and finally Section 5 concludes with practical and policy implications.

## 2 Conceptual framework

Economic and ethical viewpoints on FDI form a dichotomy that characterizes this form of foreign investment. Under a utilitarian approach, FDI projects like Eurovegas are doing good, by fostering employment and income in the host (Lam 2002). On the other hand, the corporate citizenship theory states that, “the first principle of business ethics is that the corporation is itself a citizen.” (Solomon 1993, p. 148). Foreign firms, as a “community of persons” (Melé 2012, p. 89) should contribute to the general welfare of the host country. Merging the two contexts into coherent policy and managerial action is an arduous task. Turnipseed (2002) realizes that good soldier syndrome, or the extra-role behavior that serves to advance the purposes of the organization, can result in unethical behavior. Armstrong and Green (2013) show that managers sometimes act irresponsibly by undertaking harmful actions that they would be unwilling to assume if acting for themselves.

A satisfactory synthesis of the two opposing views, “would cause ethical and economic perspectives to overlap.” (Windsor 2006, p. 95). Researchers rely on incentive-based ethics, which considers both rewards and inducements (e.g., Homann 2002; Luetge 2005; Paniagua and Sapena 2013), to blend the two perspectives. In this context, FDI is doing good, by providing policy incentives that benefit both the social and economic environment of the host.

FDI depends largely on the host’s local governance (e.g., democratic and legal

rights levels) and economic structure (e.g., freight and informational costs). In Figure 1, both contexts play a decisive role in cross-border investments. Firms decide to invest in a particular location when both spheres present a set of external and internal advantages to the firm (Dunning 1973; Helpman, Melitz, and Yeaple 2004). The economic and ethical conceptions are neither mutually exclusive, nor do they have to be equally important. They are constructs that facilitate the understanding of the effects of particular FDI varieties on the specific host's domain.

FDI is not only about movement of capital, but also about establishing a long-term relationship between host and home countries that involves more than just capital flows (Graham and Krugman 1995). Each sphere in Figure 1 has a particular influence on a different FDI flavor, such as foreign employment, the number of investment projects (extensive margin), and the monetary quantities invested (intensive margin). The intensive margin reveals information on existing FDI links, and the extensive margin sheds light on the creation of new FDI partners (Felbermayr and Kohler 2006). Local policymakers and stakeholders find distinct incentives to alter national governance in order to attract new FDI partners and higher sums of foreign capital employment.

A compartmentalized analysis of FDI ethics fails to provide adequate policies and business strategies, especially against the backdrop of today's economic downturn. Additionally, Franke and Nadler (2008) suggest that a simultaneous comparison of a variety of countries is necessary to avoid confusing cultural dimensions with national ethical attitudes. The stylized facts about FDI in Table 1 provide an additional rationale for a joint analysis of FDI types in countries at different stages in their development. First, FDI has a great impact on the LDC's society and economy. Second, as a result of the credit constraints of the ongoing recession, MDC are attracting fewer FDI projects (Gil-Pareja et al. 2013).

A golden rule for FDI ethics that stems from this conceptual framework, should

Figure 1: FDI Ethics (adapted from Windsor 2006)

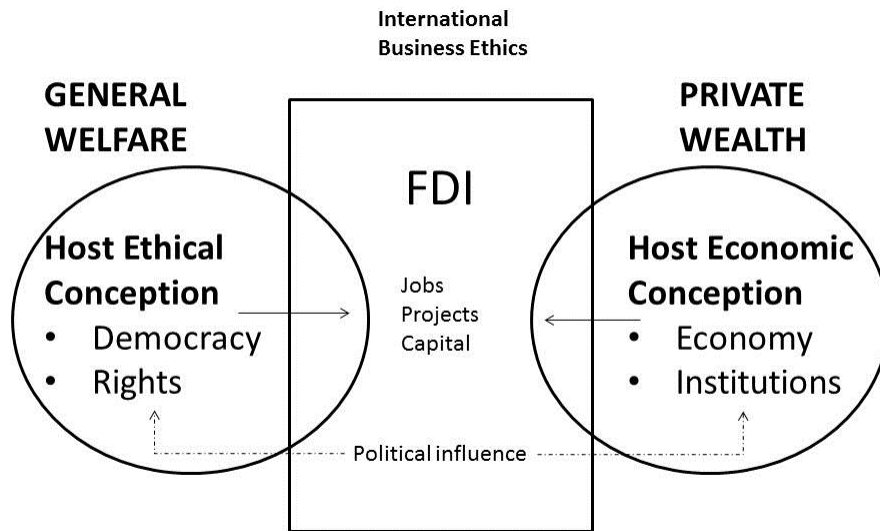


Table 1: Stylized facts about FDI (UNCTAD 2013)

FDI in Least Developed Countries LDC	FDI in More Developed Countries LDC
<ul style="list-style-type: none"> <li>• FDI inflow to LDC represents less than 2% of the total.</li> <li>• FDI inflows to LDCs hit a record high in 2012 led by developing-country TNCs, especially from India</li> <li>• LDC are using foreign firms to promote economic growth. Foreign companies in Angola must pay their taxes through local banks (including foreign-owned banks operating in Angola).</li> <li>• FDI has a clear impact on economic development in LDC. Countries like Angola have more than 40 per cent of commercial banks in the country in foreign hands.</li> </ul>	<ul style="list-style-type: none"> <li>• MDC account for most of the world's FDI inflow.</li> <li>• Transnational corporations in developed countries to maintain their wait-and-see approach towards new investments or to divest foreign assets, rather than undertake major international expansion.</li> <li>• FDI outflows from developed countries in 2012 dropped to a level close to the trough of 2009.</li> <li>• In developed countries, FDI inflows fell drastically, by 32 per cent, to \$561 billion; a level last seen almost 10 years ago.</li> </ul>

take into account the ethical sphere of general welfare (i.e., democracy and legal rights) and the economic sphere of private wealth (i.e., capital and employment).

**Proposition.** *Golden rule for FDI ethics. FDI is doing good to host countries by providing incentives which favor general welfare and private wealth.*

## 3 Empirical methodology

### 3.1 The FDI gravity equation

Nobel laureate Jan Tinbergen (1962) claims that the extent of trade between country pairs is directly proportional to their economic mass (i.e., gross domestic product, GDP) and decreases with distance, a proxy for freight costs. Like Newton's law of universal gravitation, the gravity equation is a natural way to analyze the determinants of investments across borders. The gravity equation regularly crops up in empirical research and successfully explains a variety of spatial economic interactions, such as trade, FDI, financial equities, migration, tourism, employment, and commodity flows (Anderson 2011; Bergstrand and Egger 2011; Griffith 2007).

To encompass fully the conceptual framework of IBE, the empirical approach of this study uses FDI margins and foreign jobs as dependent variables. The gravity model for FDI capital flows has a sound theoretical derivation from a general equilibrium whereby domestic and foreign enterprises coexist in a host country (Bergstrand and Egger 2007; Markusen 2002; Markusen and Venables 2000). Researchers incorporate the extensive margin in order to reduce an over-aggregation bias of capital flows (Hillberry 2002). Recent developments in the gravity literature provide a rationale for the creation of new investor partners through the estimation of the extensive margin (Anderson 2011).

Since Wilson's (1970) work giving theoretical substance to the spatial model

for commodity flows, empirical studies analyze employment data using a gravity model (Griffith 2007). Scholars carry out little empirical research on foreign employment, however, primarily due to the shortage of consistent global dyadic employment data. Seyf (2000) quantifies the relationship between FDI and jobs in the European Union. Head and Ries (2002) show how FDI shifts the high-skilled vs. low-skilled employment ratio in Japan. Paniagua and Sapena (2013) explain that multinationals transfer human capital and knowledge from the home to the host country. Using a global dataset, they demonstrate that host country endowments have a significant interaction with foreign employment.

Since dyadic FDI data is typically replete with zeros, similar empirical studies (e.g., Gil-Pareja et al. 2013; Kleinert and Toubal 2010) use non-linear specifications of the FDI gravity equation as follows:

The empirical strategy focuses on the financial channel with the following empirical equation:

$$\begin{bmatrix} FDI_{ijt} \\ N_{ijt} \\ jobs_{ijt} \end{bmatrix} = exp \left( \begin{array}{l} \beta_1 \ln(GDP_{it} * GDP_{jt}) + \beta_2 \ln(D_{ij}) + \beta_3 border_{ijt} + \beta_4 col_{ij} \\ + \beta_5 lang_{ij} + \beta_6 smctry_{ij} + \beta_7 rel_{ij} + \beta_8 BIT_{ijt} \\ + \beta_9 FTA_{ijt} + \beta_{10} rights_{jt} + \beta_{11} democ_{jt} + \lambda_{it} + \lambda_{jt} + \gamma_t \end{array} \right) + \varepsilon_{ijt} \quad (1)$$

where  $i$  and  $j$  denote FDI country partners, and  $t$  is time. The variables are as follows:  $N_{ijt}$  is the number of investment projects between home country  $i$  and host  $j$  in year  $t$ ;  $FDI_{ijt}$  is the aggregate monetary flow;  $jobs_{ijt}$  is the aggregate jobs created in country  $j$  by FDI projects;  $GDP_{it}$  and  $GDP_{jt}$  are the gross domestic products of home and host countries respectively;  $D_{ij}$  is the distance in kilometers between country capitals;  $border_{ij}$  takes the value 1 when countries share a common border, and 0 otherwise;  $col_{ij}$  (Colony) takes the value 1 if the two countries have ever had a colonial link, and 0 otherwise;  $lang_{ij}$  (Common language) takes a positive value if



both countries share the same official language;  $rel_{ij}$  (Religion) is a composite index that measures the religious affinity between country pairs with values ranging from 0 to 1;  $smctry_{ij}$  (same country) is an indicator variable that indicates if both countries were part of the same country in the past;  $BIT_{ijt}$  (bilateral investment treaty) is a dummy that takes a value of one if the country pair has a bilateral investment treaty in force;  $FTA_{ijt}$  (free trade agreement) is a dummy that indicates whether both countries have a free trade agreement in force;  $rights_{jt}$  is the strength of legal rights index in the host country, ranging from 0 (no legal rights) to 10 (full legal rights);  $democ_{jt}$  is an index that measures the democratic quality in the host country ranging from 0 (autocratic regimes) to 10 (Western democracies). Equation (1) includes fixed year dummies  $\gamma_t$ , and controls for unobserved mediating or moderating variables (Anderson and Van Wincoop 2003) in the form of fixed home and host country dummies ( $\lambda_i$  and  $\lambda_j$ ). Lastly,  $\varepsilon_{ijt}$  represents a stochastic error term.

Silva and Tenreyro (2006) propose a Poisson pseudo-maximum likelihood (PPML) estimator, which offers consistent estimates of data with zeros since this estimator does not require a log-linearization of the variables. An alternative empirical methodology for partially linear dynamic panel data (pool regression) is the Poisson maximum likelihood country-pair fixed effect (PML-CPFE) estimator (Allison 2009). Therefore, estimates of equation (1) with both PPML and PML-CPFE techniques lead to robust results. The empirical test for Proposition 1 relies on the coefficient signs for  $rights_{jt}$  and  $democ_{jt}$  in the estimate. A positive significant sign of  $\hat{\beta}_{11}$  and  $\hat{\beta}_{12}$  implies that an increase in the host's legal rights and democracy indices have a positive impact on FDI flavors. Under this scenario, policymakers face clear incentives to increase general welfare to foster FDI.

Table 2: Stylized facts about FDI (UNCTAD 2013)

	LDC	MDC
Number of FDI projects	1,146	17,001
Total jobs created	352,976	15,071,984
Average project size (jobs)	257	886
Total capital investment (million USD)	217,333	5,599,262
Average project size (million USD)	\$158	\$329
Legal Rights (average)	4.26	6.04
Democracy (average)	6.28	7.01

Table 3: List of Countries

*Least Developed Countries LDC*

Afghanistan, Angola, Bangladesh, Bhutan, Laos, Liberia, Madagascar, Malawi, Mali, Mauritania, Burkina Faso, Cambodia, Congo (DRC), Djibouti, Mozambique, Nepal, Equatorial Guinea, Eritrea, Ethiopia, Guinea, Rwanda, Senegal, Sierra Leone, Somalia, Sudan, Haiti, Togo, Uganda, Yemen, and Zambia.

*More Developed Countries MDC*

Albania, Algeria, Argentina, Armenia, Australia, Austria, Azerbaijan, Bahamas, Bahrain, Barbados, Belarus, Belgium, Bermuda, Bolivia, Bosnia and Herzegovina, Botswana, Latvia, Lebanon, Libya, Lithuania, Luxembourg, Macau, Macedonia, Malaysia, Maldives, Malta, Martinique, Mauritius, Mexico, Moldova, Brazil, Bulgaria, Cameroon, Canada, Cape Verde, Chile, China, Colombia, Costa Rica, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Dominican Republic, Ecuador, Mongolia, Montenegro, Morocco, Namibia, Netherlands, New Caledonia, New Zealand, Nicaragua, Nigeria, Norway, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Egypt, El Salvador, Estonia, Fiji, Finland, France, French Polynesia, Gabon, Gambia, Georgia, Germany, Ghana, Greece, Greenland, Guadeloupe, Guatemala, Portugal, Qatar, Romania, Russia, Saint Vincent and the Grenadines, Saudi Arabia, Serbia, Seychelles, Singapore, Slovak Republic, Slovenia, South Africa, South Korea, Spain, Sri Lanka, Guyana, Honduras, Hong Kong, Hungary, Iceland, India, Indonesia, Iran, Iraq, Ireland, Israel, Italy, Jamaica, Japan, Jordan, Kazakhstan, Kenya, Kuwait, Kyrgyzstan, Swaziland, Sweden, Switzerland, Syria, Tajikistan, Thailand, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, UK, Ukraine, United Arab Emirates, United States, Uruguay, Uzbekistan, Venezuela, Vietnam, and Zimbabwe

## 3.2 Data Analysis

In a gravity framework, FDI flows are directly proportional to their economic mass (i.e., GDP) and inversely proportional to the distance (i.e., transaction costs) between country pairs. Thus, the first six variables in gravity equation (1) are staples of the gravity equation since its initial formulation in 1962. The World Bank (2011) is the source of the GDP figure (in constant year 2000 USD). Distance, common language, colony, and border come from the CEPII (2011) database, and control for freight, information, cultural, historical, and administrative transaction costs between country pairs. Religious affinities increase the probability of economic transactions between nations with similar values and beliefs (Helble 2007). The variable religion first appears in the gravity equation as a control variable for religious affinities between trade partners (Helpman, Melitz, and Rubinstein 2008). This variable takes data from the CIA World Factbook (2011) according to the following formula for each country pair:  $\%Christian_i * \%Christian_j + * \% * + \% *$ . Institutional agreements such as free trade agreements (FTAs) and bilateral investment treaties (BITs) reduce the uncertainty in foreign investments (Bergstrand and Egger 2013). BIT's construction is manual, using data from UNCTAD (2011). The source of FTA is Head, Mayer, and Ries (2010), who complement UNCTAD (2011) data.

The above group of variables controls for structural economic factors; that is, the economic context of Figure 1. The general welfare sphere includes democracy and legal rights, which serve as proxy variables for FDI ethics (Stanley 1990). The World Bank (2011) and the Center for Systemic Peace (CSP 2012) are the sources for the legal rights index and democracy, respectively. Previous research reveals mixed empirical evidence on the effect of these variables on FDI flows (Jakobsen and de Soysa 2006; Jensen 2003; Li and Resnick 2003).

The Financial Times Ltd. cross-border investment monitor (FDIMarkets 2011)

is the source of the FDI dataset. Investment count measurement is in terms of firm-level project count and capital flows in constant year 2000 USD. Jobs is the number of people the foreign affiliate employs in each investment project. The dataset covers bilateral firm-level greenfield investments from 2003 to 2010, using an aggregation across 161 host and 120 home countries. Overall, the database is heavily unbalanced with 70% zero observations, meaning that not all countries receive investment in all years. The data summary in Table 2 is in line with the stylized facts about FDI in Table 1. On average, MDC have higher democratic standards and legal rights protection than LDC. Table 3 lists the countries under study, given the United Nations (UN) classification of LDC.

## 4 Results and discussion

The PPML regression results in Table 4 show that, overall, the gravity equation performs well, explaining more than the 60% of the variation of the dependent variables in MDC and up to 42% in LDC. Most of the independent variables are statistically significant and, in general, they have the expected sign. The results of the sensitivity analysis in Table 5 express robust estimates of the coefficients of interest. Since fixed-effects models make less restrictive assumptions than their random-effects counterparts, all variables are statistically significant.

### 4.1 Least developed countries (LDC)

Focusing on the results for LDC hosts in the first three columns of Table 4, the economic variables have expected signs. Physical distance, as a proxy for transport and information costs, is a net deterrent of all FDI varieties. Cultural distance, in the form of colonial links and common language, increases foreign capital and employment. On the other hand, religious affinity lowers the influx of FDI projects to

Table 4: Results

	<i>Least Developed Countries LDC</i>			<i>More Developed Countries MDC</i>		
	(1) <i>FDI<sub>ijt</sub></i>	(2) <i>N<sub>ijt</sub></i>	(3) <i>jobs<sub>ijt</sub></i>	(4) <i>FDI<sub>ijt</sub></i>	(5) <i>N<sub>ijt</sub></i>	(6) <i>jobs<sub>ijt</sub></i>
GDP sum	0.68	0.82	3.74**	0.19	0.70***	-0.50**
$\ln(GDP_{it} * GDP_{jt})$	(0.90)	(0.65)	(1.48)	(0.21)	(0.18)	(0.25)
Distance	-0.64***	-0.40*	-1.16***	-0.45***	-0.43***	-0.48***
$\ln(D_{ij})$	(0.27)	(0.22)	(0.44)	(0.04)	(0.02)	(0.05)
Border	0.17	-0.55	-0.70	0.016	0.01	0.07***
<i>border<sub>ij</sub></i>	(0.64)	(0.47)	(0.94)	(0.07)	(0.06)	(0.11)
Common language	0.23	0.38	0.94*	0.52***	0.53***	0.07***
<i>lang<sub>ij</sub></i>	(0.37)	(0.26)	(0.57)	(0.06)	(0.06)	(0.11)
Colony	1.21**	0.07	-0.33	0.46***	0.53***	0.46***
<i>col<sub>ij</sub></i>	(0.55)	(0.35)	(0.83)	(0.06)	(0.06)	(0.08)
Same Country	0.72	0.91	0.87	0.11	0.03	-0.19
<i>smctry<sub>ij</sub></i>	(0.84)	(0.60)	(1.30)	(0.11)	(0.10)	(0.21)
Religion	-0.20	-0.85**	-0.93	0.25*	0.23*	0.21
<i>rel<sub>ij</sub></i>	(0.62)	(0.43)	(1.14)	(0.14)	(0.12)	(0.17)
Bilateral Investment Treaty	-0.10	0.36	0.83	-0.08	-0.08**	-0.09
<i>BIT<sub>ijt</sub></i>	(0.39)	(0.24)	(0.50)	(0.05)	(0.04)	(0.06)
Free Trade Agreement	-0.66*	0.05	-0.79*	-0.03	-0.06	0.17
<i>FTA<sub>ijt</sub></i>	(0.40)	(0.26)	(0.47)	(0.06)	(0.04)	(0.09)
Legal Rights	0.32***	0.38***	0.50***	-0.03	-0.08***	-0.05
<i>rights<sub>jt</sub></i>	(0.07)	(0.09)	(0.17)	(0.03)	(0.03)	(0.04)
Democracy	0.001	-0.01	-0.06**	0.001	-0.01*	-0.02***
<i>democ<sub>jt</sub></i>	(0.02)	(0.02)	(0.05)	(0.004)	(0.004)	(0.01)
Observations	1146	1146	1146	28665	28610	28626
$R^2$	0.34	0.23	0.42	0.66	0.63	0.60

Notes: Robust standard errors in parentheses, Fixed dummies: Country and year. Estimation Method: PPML

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

Table 5: Results (CFPE)

	<i>Least Developed Countries LDC</i>			<i>More Developed Countries MDC</i>		
	(1) <i>FDI<sub>ijt</sub></i>	(2) <i>N<sub>ijt</sub></i>	(3) <i>jobs<sub>ijt</sub></i>	(4) <i>FDI<sub>ijt</sub></i>	(5) <i>N<sub>ijt</sub></i>	(6) <i>jobs<sub>ijt</sub></i>
GDP sum	0.76***	0.83	3.65***	0.17***	0.67***	-0.57**
$\ln(GDP_{it} * GDP_{jt})$	(4.5e-5)	(0.71)	(0.05)	(6.50e-06)	(0.10)	(0.01)
Bilateral Investment Treaty <i>BIT<sub>ijt</sub></i>	-1.10***	-0.80	2.60***	0.21***	0.05	0.003
	(7.8e-5)	(0.24)	(0.33)	(5.34e-06)	(0.09)	(0.004)
Free Trade Agreement <i>FTA<sub>ijt</sub></i>	-2.61***	0.39	0.13**	-0.002***	0.28***	0.382***
	(2.5e-4)	(0.74)	(0.06)	(5.44e-06)	(0.08)	(0.01)
Legal Rights <i>rights<sub>jt</sub></i>	0.31***	0.39***	0.47***	-0.03***	-0.09***	-0.07***
	(4.19e-6)	(0.08)	(0.01)	(9.15e-07)	(0.02)	(0.001)
Democracy <i>democ<sub>jt</sub></i>	0.01***	-0.02	-0.06**	-0.002***	-0.01*	-0.02***
	(1.26e-06)	(0.02)	(0.001)	(1.39e-07)	(0.002)	(0.001)
Observations	1008	1008	1008	18486	18486	18486
$R^2$	137	137	137	2530	2530	2530

Notes: Robust standard errors in parentheses, Fixed dummies: Country pair and year. Estimation Method: PML-CPFE  
\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

LDC. Therefore, proximity is the key dimension for private wealth creation through FDI. Institutional and economic factors in the form of economic activity (i.e., GDP) and international agreements have a slight influence. For example, GDP has a clear and positive effect only for job creation, and free trade agreements have a negative impact just on FDI flows.

In the ethical sphere, the law exerts the main transversal influence on FDI. The extent of legal rights has a clear positive impact on all three FDI flavors. Foreign enterprises are signaling their preference for countries that increase the protection of legal rights, in line with the results of Jakobsen and De Soysa (2006). Therefore MDC policymakers have a clear incentive to increase and protect legal rights.

The level of democracy has no significant effect on either FDI flows or new project creation. Furthermore, LDC face a job dilemma. An increase of one point in the legal rights scale raises foreign employment 68% on average (calculated by  $(\exp(0.5) - 1) * 100\%$ ), while the same increase in the level of democracy decreases foreign employment by 6%.

## 4.2 More developed countries (MDC)

Turning attention to the economic sphere, few differences emerge between LDC and MDC. While economic activity (i.e., GDP) has a clear and expected effect on project creation, this variable has a negative effect on employment. Higher wage costs and inflation linked to growth explain this result (Rodrik 1999). Other variables (common language, colony, and religion) display the expected positive signs. Investment treaties, however, have a mild negative effect on projects, possibly due to an endogenous effect (Bergstrand and Egger 2013).

In the ethical arena, the picture is bleak in MDC. Legal rights have no significant effect on jobs and FDI flows, and a mild negative effect on the extensive margin. On average, increasing one point in the legal or democratic scales reduces the number of FDI projects by 8% and 1%, respectively. A point increase in the level of democracy reduces foreign employment by 2% on average. Investors become adversely selective regarding democratic rights. The FDI–democratic rights elasticity is higher for LDC than for MDC, meaning that small variations in democratic governance have a higher impact in LDC.

## 5 Implications

The goals for this study include providing empirical findings on the impact of the level of democracy and legal rights on FDI capital flows, projects, and employment. This conceptual and empirical research provides some insights into resolving these issues, offering several contributions to the IBE and FDI literature. The paper provides academic, managerial, and policy perspectives related to international business ethics and economic development.

Previous empirical studies argue that democratic political systems come at tremendous costs (e.g., higher wages), and attract lower levels of international invest-

ment than their authoritarian counterparts (Agosin and Machado 2005; Li and Resnick 2003; Mathur and Singh 2013; Moran et al. 2005; Siegel et al. 2013). Nonetheless, several studies highlight a positive impact of democratic standards on the levels of capital inflows in LDC (Jakobsen and de Soysa 2006; Jensen 2003).

The present research refines the understanding of previous contradictory studies. The host's economic development stage has a mediating role in FDI. The effect and elasticity of democratic rights on FDI types vary with the economic development of the host. Therefore, one-size-fits-all FDI policies and business strategies fail to promote private and general wealth simultaneously in host countries.

The findings of this study depict a philanthropic investment world (Windsor 2006). FDI is doing good to LDC, by providing beneficial incentives for the well-being of the host community. Outside this non-exclusive club of countries, however, FDI is more resilient to variations in legal rights levels and has a mild influence on the legal and democratic functioning of MDC hosts.

LDC policymakers face a dilemma in terms of job creation. To foster employment in LDC, democracy and legal rights cannot grow simultaneously and fully. Rodrik's (2011) impossibility theorem for the global economy offers a theoretical foundation for this empirical result; democracy, national sovereignty, and global economic integration are mutually incompatible in a globalized economy.

## **5.1 Practical and policy implications**

A main concern for governments today is how to make best use of the country's national advantages to foster FDI and employment. This study provides useful hints to determine the best instruments and initiatives for governments to influence FDI. In this research, policymakers can find granular results to help tailor policies for target outputs. For example, reinforcing legal rights through international treaties and conventions (e.g., the 1958 New York Convention on the Recognition and Enforce-



ment of Foreign Arbitral Awards) encourages higher levels of foreign employment and new investment projects.

In this paper, managers can find a way to ascertain foreign investment decisions following an ethical approach. Additionally, this research uncovers lessons that practitioners can exploit as a strategic lever for increasing corporate reputation and market opportunities; for example, through philanthropic FDI projects in LDC.

## **5.2 Limitations and future research**

This paper does have limitations, many of which are an invitation to conduct future research. The country sample, for example, is broad and includes all economic sectors. Although findings are robust across many countries, the relationships might be less applicable to specific destinations or industries.

Future research exploiting the applicability of these findings to different countries, sectors and firms is an exciting prospect. For example, the study overlooks contingent factors such as firm size. This study leans toward mainly capturing the effect of larger enterprises, which account for a bigger share of FDI (Mayer and Ottaviano 2008). The results may, therefore, show some bias towards transnational corporations and be less applicable to small and medium-sized firms.

Finally, the main contribution of this paper is to examine differential characteristics of FDI in international business ethics. The golden rule in this study, however, presents commonalities that may have applications to or generalizations for other international enterprises. Future studies could capture the effect of other systemic variables such as business climate, trust, or corruption in intra-firm trade or foreign affiliate sales.

## 6 Conclusions

The purpose of this paper was to develop an econometric model to estimate the effect of financial constraints on the foreign employment. The model in this study is, apparently, the first to explain FDI's jobs in the context of financial frictions. The empirical application of the model to a global dataset during 2003-2010 highlights that credit constraints at the country of origin reduces foreign jobs in higher numbers than domestic employment.

This study proves useful to determine policy instruments and initiatives to foster foreign employment; for example, intra-firm financing or third party financial endorsement (e.g. the host). Moreover, this study contributes to a better understanding of the record high unemployment rates in relatively open economies (e.g. Spain, Portugal, and Italy).

This letter does have limitations, many of which are an invitation to future research. For example, this paper overlooks MNE's endogenous financing and affiliate's reinvestment. This study may, therefore, show some bias towards smaller transnational corporations. Future research exploring the applicability of this model to FDI intra-firm financing is encouraged.

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