

Shareholder Protection, Ownership Concentration and FDI

By

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Abstract

Host country's weaker legal shareholder protection may make it costlier for parent shareholders to monitor the foreign subsidiary and hold managers accountable in case of misconduct. This prospect may motivate the managers to invest in such foreign environments. However, the agency costs associated with such investments can increase as well. The latter would tend to discourage such FDI. We test this ex ante uncertain relationship using a sample of publicly quoted UK parents that established new, majority owned joint venture subsidiaries in continental Europe. We find that host country's weak legal shareholder protection discourages FDI. This negative relationship, however, is less important for firms with higher ownership concentration, implying that parent's ownership concentration may be a substitute for host country's weak legal shareholder protection.

Keywords: *FDI, agency costs, shareholder protection*

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1. Introduction

When ownership is separate from control, managerial investment decisions may be motivated by the pursuit of private benefits rather than by shareholder value maximization (Jensen 1986, Aggarwal and Samwick 2006). For example, the managers may overinvest and build empires as increased size allows them to derive more private benefits (Hart and Moore, 1995). However, poor investment decisions are less likely if there are effective governance mechanisms such as strong legal shareholder protection or high ownership concentration (La Porta et al, 1998, Shleifer and Vishny, 1986).

The concern that managerial investment decisions may conflict with shareholder interests can be extended to foreign direct investment (FDI) decisions. If multinationalization makes the firm more complex (Kim, 2000) and, hence, harder to monitor, managerial autonomy and scope for pursuing private benefits can increase. Examples include Tyco and Parmalat. The managers of these firms used subsidiaries in countries with weak regulatory scrutiny to facilitate concealment and diversion (Desai, 2005). Hence, the concern that FDI may be motivated by managerial pursuit of private benefits rather than by shareholder value maximization is not unfounded.

We focus on a sample of publicly quoted UK firms, and explore whether FDI location decisions are affected by the host country's level of legal shareholder protection and the parent firm's ownership concentration. A priori the relationship between host country shareholder protection and FDI is uncertain. As we argue in more detail in the next section, at least for joint venture (JV) subsidiaries, there are reasons to believe that host country's weaker legal shareholder protection may make it costlier for shareholders

to monitor the subsidiary and hold managers accountable. This prospect may motivate the managers to invest in such environments. However, the agency costs associated with such investments can increase too. The latter would tend to discourage such FDI. We explore the relationship between FDI location choice and host country's level of shareholder protection for a sample UK parents that established majority owned foreign JVs in Western and Eastern Europe. We find that weaker shareholder protection in the host country discourages FDI. This negative relationship, however, is weakened as the ownership concentration of the parent firm increases implying that parent's ownership concentration may be a substitute for host country's weak legal shareholder protection.

To the best of our knowledge, the existing literature on FDI determinants has not explored the possible interaction of host country's level of legal shareholder protection (an external monitoring mechanism) and the parent firm's ownership concentration (an internal monitoring mechanism). Studies that analyzed the relationship between host country's legal shareholder protection and firm level FDI do not account for the role of internal governance mechanisms such as ownership concentration (Rossi and Volpin, 2004, Bris and Cabolis, 2008).¹ Studies that investigate how the firm's ownership characteristics affect its FDI decisions, use aggregate firm level data and ignore variations in host country characteristics (Filatotchev et al 2006, Tihanyi et al, 2003, Sanders and Carpenter, 1998). Our work adds to the existing literature by accounting for both the external and the internal monitoring mechanisms, i.e. the host country's strength of legal shareholder protection and the investing firm's ownership concentration.

¹ Bris and Cabolis (2008) compare ownership concentrations for cross-boarder versus domestic acquirers and find that the former have a lower ownership concentration. However, they do not explicitly account for ownership concentration in their empirical models.

The paper is organized the following way. In Section 2 we explain in more detail why the host country's legal shareholder protection and the parent firm's ownership concentration may matter for FDI decisions. Section 3 describes the variables and the data. Section 4 presents the models and the estimation results. Section 5 concludes.

2. Why Host Country's Legal Shareholder Protection and Parent Firm's Ownership Concentration can Matter for FDI

Recent research suggests that managerial ability to pursue private benefits is limited in countries with strong legal shareholder protection (La Porta et al 1998). US and UK are considered to have strong legal shareholder protection. Strong protection at home implies high disclosure of transactions and ease of proving managerial misconduct (Djankov et al 2008). High disclosure requirements and the relative ease with which the shareholders can sue the managers are likely to deter managerial misconduct. However, strong legal shareholder protection in the home country may not easily extend its coverage to firm's operations abroad, as subsidiaries may be subject to the corporate laws of the host country.

If the foreign subsidiary is fully (100%) owned, according to International Corporate Law, it is subject to the corporate laws of parent's home country (Bris and Cabolis, 2008). Then, strong shareholder protection at home is likely to "travel" to fully owned subsidiaries. In a sample of cross-boarder acquisitions, Bris and Cabolis (2008) found that better shareholder protection in the acquirer's country results in higher target returns for 100% acquisitions – an evidence that the export of good governance is

expected to improve performance. This effect, however, was not significant for acquisitions of less than 100%.

Most of our sample foreign subsidiaries are majority (over 50%) owned by UK publicly quoted parents. However, most of them are joint ventures, i.e. less than 100% owned by the parents. The transferability of home country's strong shareholder protection laws to the foreign subsidiary may be problematic with joint ventures. According to the principle of extraterritoriality, if less than 100% of the subsidiary is owned by the foreign firm, the host country is considered to be the subsidiary's domicile and it may be subject to host's corporate laws (Muchlinski, 1997). Then weaker shareholder protection in the host country may lower the subsidiary's quality of governance. For example, in host countries with weaker legal shareholder protection, disclosure requirements are more protective of commercial information. The home country courts have to extend their reach to subsidiary's host country to order the production of such information (Muchlinski, 2007). However, according to the same source, British courts have been unwilling to 'lift the corporate veil' and order the disclosure of documents located in overseas subsidiaries. This may allow the managers to hide subsidiary related "unpleasant" information from home investors. The difficulty of obtaining subsidiary related information can make it harder to determine parent management's share of responsibility if subsidiary misconduct is suspected, which will make the litigation of management more difficult. Litigating the subsidiary itself can become harder as well. There is judicial discretion involved in determining whether the subsidiary falls under the jurisdiction of the parent's home country or the host country where it is domiciled (Muchlinski, 2001). If the foreign subsidiary's activities hurt the parent's shareholders,

the burden of proof is on the shareholders to establish that host country's forum will not provide substantial justice. The forum choice - home versus host country, will be important if the host country's courts are less shareholder friendly. This judicial discretion over the appropriate jurisdiction for the subsidiary can increase uncertainty and costs of litigation. Host country's more lenient penalties for corporate misconduct can further weaken the disciplining role of shareholder lawsuits. It may become easier for parent's managers to explicitly or implicitly encourage the local employees of the subsidiary to participate in misconduct. For example, in the case of Royal Ahold, a company in The Netherlands where legal shareholder protection is much weaker than in US and UK, the managers received minimal penalties for corporate fraud whereas in US they would have received more than ten years in prison for a conviction on the same facts (Knapp et al, 2009).

If host country's weak legal shareholder protection makes it harder to detect subsidiary related misconduct and/or punish for it, managerial ability to pursue private benefits can increase. This prospect may motivate the managers to invest in such environments. However, the increased agency costs associated with such investments may serve as a deterrent. The market may recognize the activities in which managerial ability to pursue private benefits increases. Even if firm value maximization is the motive for FDI, if managerial autonomy is high and if it is hard to detect and/or prove managerial misconduct in the host country, markets may react accordingly. According to Shleifer and Wolfenzon (2002), the increased ability of managers to divert shareholder wealth may reduce share prices. This can jeopardize managerial job security due to

increased investor discontent and heightened takeover threats.² Therefore, a priori it is uncertain whether or not the managers invest more in countries with weak shareholder protection laws.

We test this ex ante uncertain relationship between the FDI location choice and host country's level of legal shareholder protection for a sample of publicly quoted UK firms that undertook new investments in Continental Europe between 1998 and 2001. The absolute majority of our sample subsidiaries are majority owned joint ventures. Host country legal shareholder protection strength is measured by the index obtained from the World Bank Doing Business database.³ This measure is based on Djankov et al. (2008). In the main body of the paper, we use the sample of UK parents that had majority owned JVs only. We estimate both a logit model (including a fixed effect model) and a two-step Heckman selection model. We account for various control variables and perform a variety of robustness checks. Samples with and without transition host countries are used. In all cases we find that weak legal shareholder protection in the host country reduces the likelihood of FDI. The results are robust to including the small number of fully and minority owned foreign subsidiaries and are reported in the Appendix.

We further check if host country's level of legal shareholder protection has a differential impact on firms with varying ownership concentrations. Higher ownership concentration is often associated with lower managerial autonomy (Aghion and Tirole 1997) and increased shareholder ability and willingness to monitor the managers (Shleifer and Vishny 1986). It can serve as a substitute for shareholder legal protection (La Porta, et al 1998). According to Hill (1995), major UK investors are informed and

² According to Morek et al (1988), a low Tobin's q is a characteristic of hostile takeover targets. According to Mayer and Renneboog (1998), of all European economies, UK has the most active takeover market.

³ www.doingbusiness.org

sound their opinion about major changes in corporate strategy; if they are critical of managerial proposals, those may be cancelled. Frank et al (2001) and Mallin (1996) also confirm the activist role of major UK investors. In firms with higher ownership concentration, the owners' increased ability and willingness to monitor the managers can serve as a substitute to host country's weak legal shareholder protection and reduce managerial ability to pursue private benefits from FDI. Consistent with this hypothesis, we find that host country's legal shareholder protection is less important for firms with higher ownership concentration.

3. Models, Variable Definitions and Data

Models

First, we estimate the following logit model

$$\begin{aligned} FDI_{ic} &= 1 \text{ if } FDI_{ic}^* > 0 \\ FDI_{ic} &= 0 \text{ otherwise} \end{aligned} \tag{1}$$

where

$$FDI_{ic}^* = \beta_1 X_{ic} + u_{ic}$$

where the dependent variable takes on the value of one if firm i has invested in country c and zero otherwise. For each firm the number of observations is equal to the number of possible destination countries in the sample.

We also estimate a two step Heckman selection model, where the dependent variables are the dummy variable FDI_{ic} capturing the location choice, and the natural

logarithm of the volume of FDI, $\ln(\text{vol FDI}_{ic})$, by firm i in country c given that firm i has invested in country c .⁴

In the first step, a decision is made whether to invest or not in a particular host country:

$$\begin{aligned} \text{FDI}_{ic} &= 1 \text{ if } \text{FDI}_{ic}^* > 0 \\ \text{FDI}_{ic} &= 0 \text{ otherwise} \end{aligned}$$

In the second step, a decision is made about the volume of investment:

$$\begin{aligned} Y_{ic} &= \ln(\text{vol FDI}_{ic}^*) \text{ if } \text{FDI}_{ic} = 1 \\ Y_{ic} &= \text{missing} \text{ if } \text{otherwise} \end{aligned} \quad (2)$$

where

$$\begin{aligned} \text{FDI}_{ic}^* &= X_1' \beta_1 + u_{ic} \\ \ln(\text{vol FDI}_{ic}^*) &= X_2' \beta_2 + v_{ic} \end{aligned}$$

Heckman's (1979) two-step procedure is used to estimate this model.

Independent Variables

The legal shareholder protection index (SP) for each host country is taken from the World Bank's Doing Business Project. It is based on the index developed by Djankov et al. (2008) but is updated and includes more countries. For each country, it measures the level of transparency of related party transactions (disclosure level), the extent of director liability and the ease of shareholder lawsuits. The latter is based on the ease of obtaining information that can prove specific facts or that is relevant to the subject matter of the claim, and the ease of questioning the defendants and the witnesses during the trial. A

⁴ Gorg et al. (2009) uses this approach to analyze the FDI decisions of German firms in India.

higher *SP* implies a stronger legal shareholder protection. The index is based on a survey of corporate lawyers and has been used in several studies.⁵

Following La Porta et al (1998) we use the percentage of shares held by the *three* largest owners as a measure of ownership concentration (*Concentration*). We follow La Porta et al (2002) in modeling ownership as exogenous. They argue that ownership patterns are extremely stable, especially outside US. The ownership information pertains mostly to years 1999 and 2000; for a few firms the date of ownership information is the end of 1998 or early 2001. This variable is interacted with *SP* described above.

The variable *Presence* is a dummy variable equal to one if firm *i* had an existing subsidiary in host country *c* prior to establishing a new subsidiary.

Other firm level variables include firm size and entry costs. Firm size, labeled *Size*, is measured as the lagged natural logarithm of total assets (prior to the decision to undertake FDI). The lagged ratio of tangible fixed assets to total assets is used as a proxy for *Entry costs* (Lambson and Jensen, 1998; see section 4.2 for more).

We also control for other host country characteristics that could impact FDI⁶: the country-level quality of governance, population size, taxes and per capita GDP.

The host country *Governance* index comes from the *Global Competitiveness Report 2001-2002* (World Economic Forum). It is based on an extensive survey of managers and intends to capture the possibility of expropriation of assets, corruption, insecurity of property rights and contracts. A higher score implies better quality of governance.

⁵ Haidar (2009), Doidge et al. (2007), etc.

⁶ See, for example, Blonigen (2005) for a review of the literature on FDI determinants.

The logarithm of population size (*Population*) is intended to proxy for market size. It comes from the World Bank *World Development Indicators* and it pertains to 1999.

Another potentially important factor influencing the FDI location is the level of corporate taxation in the host country, as demonstrated by Hines (1996) and Devereux and Griffith (1998). Hence we employ the corporate tax rates (*Tax*) as reported by KPMG, 1999.⁷ All taxes are expressed in percentages. For some transition countries this rate is missing. Either we find the rate from other internet sources or replace it with the rate from the closest year available. As an additional precaution, we do our estimations without the transition countries.

Per capita GDP, GDP_{pc} , is aimed to proxy the purchasing power of consumers in the host country. It is also often used as a proxy for host country's market size.⁸

Transition, the dummy variable for transition countries aims to control for other differences between industrialized and transition economies that may not be captured by the explanatory variables. For instance, if a large presence of foreign investors encourages subsequent inflows due to agglomeration effects and transmission of knowledge about the host country to source economies, transition countries are at a disadvantage vis-à-vis Western Europe as they have opened to FDI relatively recently.

⁷ KPMG's Corporate Tax Rate Survey (www.kpmg.com).

⁸ We also tried the variable WAGE that accounts for destination country's labor costs by using the average wage rate calculated as the average of wages paid by the top 10,000 firms in each country (top 10,000 firms in decreasing order of total assets and with more than 5 employees in 1999). Higher wages proxy labor costs and can discourage FDI. However, higher wages can also proxy higher productivity and attract more FDI. However, there is a high correlation between WAGE and GDP_{pc} creating a potential multicollinearity problem. The sign and significance of GDP_{pc} was very sensitive to the inclusion of WAGE. Hence we dropped it. However, the inclusion of WAGE had no impact on our main results.

Data

Our analysis is based on data on new subsidiaries established between 1998 and 2001 by publicly quoted UK companies in Western and Eastern European countries. The information comes from the Amadeus database compiled by Bureau Van Dijk which covers only European subsidiaries.

We construct the data set on new subsidiaries by comparing the subsidiary listings for parent companies included in both the 1998 and the 2001 releases of the Amadeus database. The subsidiary ownership information pertains mostly to years 1999 and 2000.

The initial sample consists of all firms that have invested in at least one country in Continental Europe between 1998 and 2001 and for which we have information on the largest three owners and host country characteristics described in the previous section. This results in 109 parent UK firms. Of these, 93 had established only a majority owned joint venture subsidiary in at least one of the 21 possible destination countries.⁹ The other 16 parents had established either minority owned or wholly owned subsidiaries. In the main body of the paper, we use the sample with parents that had majority owned JVs only. The total number of observations for our main sample is $93 \times 21 = 1953$. The summary statistics for this sample are provided in Table 1 below.

⁹ The list of destination countries is the following: Austria, Belgium, *Bulgaria*, Switzerland, *Czech Republic*, Germany, Denmark, *Estonia*, Spain, Finland, France, *Hungary*, Ireland, Italy, The Netherlands, Norway, *Poland*, Portugal, *Romania*, Sweden, *Slovenia*. The transition (former socialist) countries are italicized.

Table 1. Summary statistics

Variable	Mean	Std. Dev.	Min	Max
<i>Dependent Variables</i>				
FDI (dummy)	0.13	0.34	0.00	1
lnVolFDI ¹⁰	0.38	1.15	0	7.99
<i>Host Country Control Variables</i>				
<i>Shareholder Protection</i>				
(index)	5.62	1.1	3	8.3
<i>Population</i> (logarithm)	16.2	1.07	14.18	18.22
GDP _{pc} (logarithm)	9.47	0.99	7.36	10.5
<i>Governance</i> (index)	5.5	0.93	3.2	6.5
<i>Taxes</i> (percentage)	31.8	6.8	18	50
<i>Transition</i> (dummy)	0.33	0.47	0	1
<i>Firm Level Control Variables</i>				
<i>Concentration</i> (percentage)	23.8	9.64	10.77	61.8
<i>Firm Size</i> (logarithm of lagged assets)	7.05	1.09	5.6	10.25
<i>Entry costs</i> (lagged ratio of tangible fixed assets to total assets)	0.38	0.22	0	0.95
<i>Presence</i> (dummy)	0.76	0.42	0	1

The mean of our sample *Concentration*, the variable measuring the ownership concentration for the largest three owners, is 23.8%, which is not much different from the average of about 20% reported by La Porta et al (1998) for UK publicly traded firms.

We also check the model by excluding the transition countries. This reduces the sample size. The number of parent firms reduces to 91 and the number of destination

¹⁰ The summary statistics for this variable are based on a transformation that adds 1 to the dollar amount of FDI to allow taking logarithms.

countries reduces to 14. The mean of the FDI dummy now increases to 0.19 and the mean of $\ln\text{VolFDI}$ increases to 0.53. The mean for host country tax rate increases to 33.8, the mean of $\text{GDP}(\text{logarithm})$ increases to 10.1 and the mean of Governance index increases to 6. The rest of the summary statistics change slightly.

4. Estimation Results

4.1. Logit Results

Tables 2 and 3 report the estimation results for the logit model using the sample of those UK parents that established majority owned joint ventures only. Table 2 excludes the parent firm's ownership concentration (*Concentration*) and its interaction with the host country's legal shareholder protection level (*SP_Conc*). In specification (1) parent's size and all host country level variables described in section 2.1 are included. Since, according to the reported correlations in the Appendix, there is a high correlation between host countries' GDP_{pc} and *Governance*, a potential multicollinearity problem may exist. In specification (2) we drop GDP_{PC} and in specification (3) we drop *Governance*.¹¹ Specifications (4)-(6) mirror specifications (1)-(3) without transition countries, since data reliability from these countries might be questioned.

SP is positive and consistently significant at 1% level across all specifications, implying that the likelihood of FDI (majority owned JVs, to be more precise) is higher in host countries with better shareholder protection. This result is consistent with the hypothesis that even though a weak legal shareholder protection in host country may facilitate managerial pursuit of private benefits and encourage FDI, investors can recognize this threat which can adversely affect share prices and deter managers from

¹¹ We also tried the level of host country's labor costs (see footnote 6).

undertaking investments in such environments. The odds ratio for *SP* (not reported in the table) was between 2.1 and 2.3 across all specifications, implying that the odds of attracting a joint venture FDI increased 2.1-2.3 times for every one unit increase in host country's *SP*.

Of the other control variables, *Presence*, *Population*, *Taxes* and *Governance* are consistently significant across all specifications. *Presence* is a dummy variable equal to one if the parent firm had an existing subsidiary in the host country. According to our results, establishment of a new subsidiary is less likely if there is already an existing subsidiary. Entry into host countries with larger populations and better governance is more likely. Higher taxes, in contrast, make entry less likely. The behavior GDP_{pc} depends on specification. In the larger sample that includes transition host countries (specifications (1) and (3)), it is significantly positive. In the smaller sample (without transition host countries), it becomes insignificant when used with *Governance*.

In columns (1) and (2) of Table A1 in the Appendix, we report the estimation results of specifications (1) and (4) using a fixed effects logit model.¹² The fixed effects model allows to alleviate the problem of unobserved firm level heterogeneity. A similar model was used by Blonigen et al (2005) for analyzing the FDI location decisions of Japanese firms. The results from the fixed effects model are very similar to the results reported in Table 2.

We also estimate model (1) using the original, larger sample that included the 93 parents with majority owned joint venture subsidiaries only plus the remaining 16 parents that had either minority owned or wholly owned subsidiaries. The results are in Table A2.

¹² To save space, we didn't report the fixed effect logit results for specifications (2), (3), (5) and (6) as they were very similar to Table 2 results.

However, we are careful not to claim that host country's strong *SP* can make all types of FDI more likely based on the small number of minority and wholly owned subsidiaries that we have.

TABLE 2. Logit Estimation of Model (1) without parent's ownership concentration and its interaction with host country's level of legal shareholder protection. Cluster-robust standard errors are in parenthesis (clustering is done over the firms).

	(1)	(2)	(3)	(4)	(5)	(6)
SP	0.796*** (0.116)	0.743*** (0.11)	0.848*** (0.109)	0.772*** (0.123)	0.744*** (0.116)	0.852*** (0.111)
Presence	-3.991*** (0.316)	-3.99*** (0.311)	-3.989*** (0.316)	-3.883*** (0.318)	-3.876*** (0.312)	-3.883*** (0.319)
GDPpc	1.011*** (0.37)		1.202*** (0.358)	0.641 (0.444)		0.926** (0.407)
Population	0.999*** (0.17)	0.85*** (0.152)	1.077*** (0.169)	0.997*** (0.17)	0.913*** (0.153)	1.107*** (0.164)
Taxes	-0.144*** (0.023)	-0.141*** (0.022)	-0.137*** (0.021)	-0.157*** (0.022)	-0.157*** (0.022)	-0.145*** (0.02)
Transition	-0.064 (0.772)	-1.629*** (0.408)	-0.339 (0.747)			
Governance	0.494*** (0.177)	0.657*** (0.179)		0.632*** (0.191)	0.745*** (0.184)	
Parent Firm's Size	0.112 (0.098)	0.109 (0.097)	0.101 (0.097)	0.049 (0.104)	0.045 (0.103)	0.036 (0.103)
Constant	-29.867*** (5.609)	-17.969*** (2.682)	-30.537*** (5.391)	-25.916*** (6.113)	-18.559*** (2.534)	-27.548*** (5.759)
N	1953	1953	1953	1274	1274	1274
Pseudo Rsq	0.51	0.51	0.51	0.45	0.45	0.45
Wald Chi2	299.7***	312.7***	294.8***	272.32***	257.03***	228.05***
Log Likel	-353.4	-356.1	-355.7	-324.4	-325.3	-327.5

*p<=0.1, ** p<=0.05, *** p<=0.01

Table 3 reports the logit estimation results involving the parent's ownership concentration and its interaction with host country's *SP*. The inclusion of concentration and its interaction with *SP* is motivated by the argument that ownership concentration can

be a substitute for legal shareholder protection. In this case, we would expect parent's ownership concentration to be a substitute for host country's low *SP*. Higher *Concentration* can increase owners' ability and willingness to monitor the managers. If true, then host country's legal shareholder protection is less important for shareholders in more concentrated firms. They rely less on host country's legal institutions to protect their interests from managerial opportunism.

According to Table 3, both *SP* and *Concentration* and their interaction are significant. However, Stata's reported marginal effect of the interaction term in Table 3 can be misleading. In non-linear models, both the sign and the significance of the interaction effect will vary from observation to observation as it will depend on other covariates (Ai and Norton, 2003). We calculate the correct interaction terms following Ai and Norton (2003) using Stata's `inteff` command. The results are reported in Figures 1 and 2. Figure 1 plots the interaction coefficient and its statistical significance for specifications (1)-(3) of Table 3. Figure 2 does the same for specifications (4)-(6). For example, according to the upper left-hand side graph of Figure 1, in specification (1) the interaction effect is negative for the absolute majority of observations. According to the right-hand side graph of Figure 1, the interaction effect is significantly negative for a large number of observations with predicted probabilities of about 0.5 or larger. According to Figures 1 and 2, for each specification there are a large number of observations for which the interaction effect is negative and statistically significant, implying a substitutability between parent's ownership concentration and host country's level of *SP*.

The behavior of other determinants of FDI is similar to those reported and discussed before.

In columns 3 and 4 of Table A1 in the Appendix, we report the estimation results of specifications (1) and (4) using a fixed effects logit model. Parent invariant variables (Concentration and Size) are automatically dropped. The results for the rest of the variables are very similar to the ones reported in columns (1) and (4) of Table 3.¹³

TABLE 3. Logit Estimation of Model (1) including parent's ownership concentration and its interaction with host country's level of legal shareholder protection. Cluster-robust standard errors are in parenthesis (clustering is done over the firms).

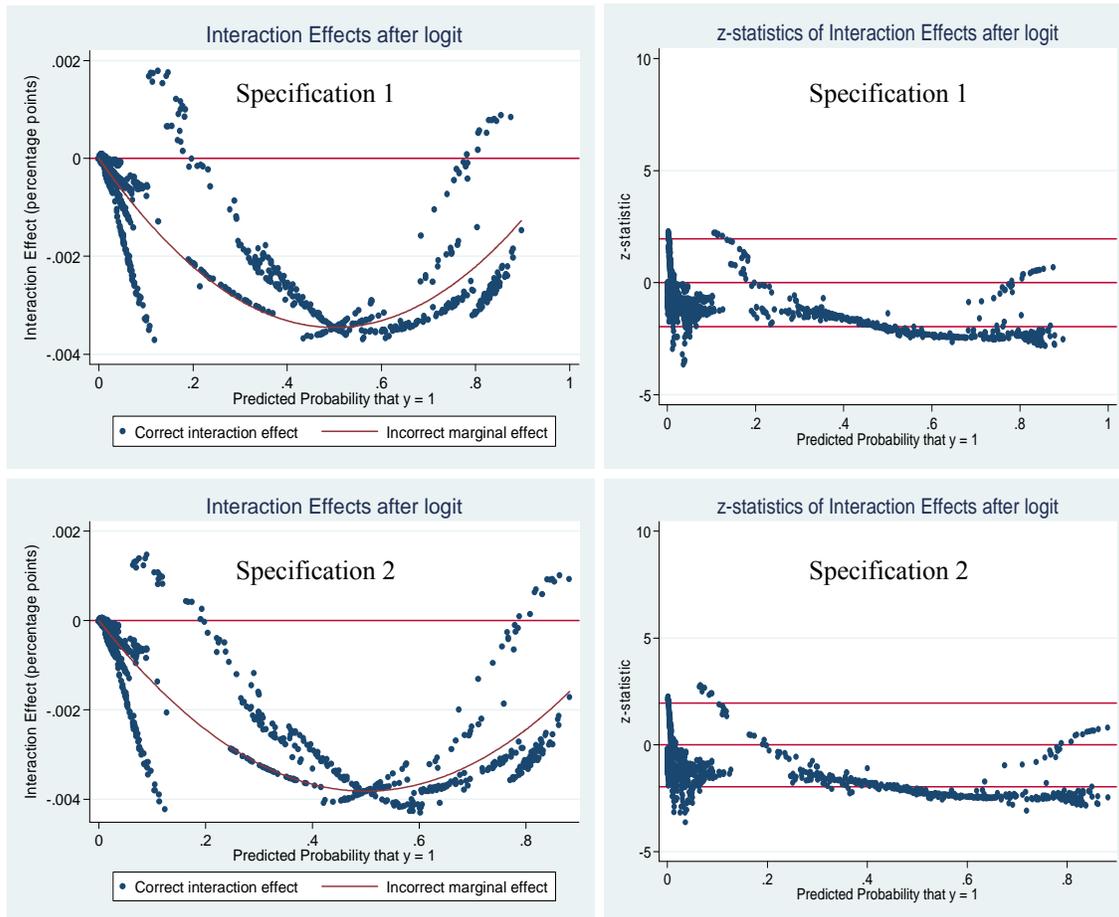
	(1)	(2)	(3)	(4)	(5)	(6)
SP	1.108*** (0.178)	1.089*** (0.186)	1.118*** (0.176)	1.09*** (0.173)	1.085*** (0.178)	1.116*** (0.164)
Concentration	0.084** (0.036)	0.091** (0.037)	0.073** (0.037)	0.085*** (0.035)	0.091*** (0.036)	0.071** (0.034)
SP_Conc	-0.014** (0.007)	-0.015** (0.007)	-0.012* (0.007)	-0.014** (0.006)	-0.015** (0.007)	-0.012* (0.007)
Presence	-3.998*** (0.314)	-3.998*** (0.309)	-3.994*** (0.314)	-3.887*** (0.316)	-3.881*** (0.311)	-3.885*** (0.317)
GDPpc	1*** (0.375)		1.209*** (0.36)	0.625 (0.453)		0.933 (0.409)
Population	0.99*** (0.17)	0.843*** (0.153)	1.072*** (0.169)	0.987*** (0.17)	0.906*** (0.154)	1.103*** (0.165)
Taxes	-0.143*** (0.023)	-0.14*** (0.022)	-0.136*** (0.021)	-0.156*** (0.022)	-0.156*** (0.022)	-0.144*** (0.021)
Transition	-0.019 (0.767)	-1.558*** (0.411)	-0.311 (0.745)			
Governance	0.528*** (0.188)	0.696*** (0.191)		0.671*** (0.205)	0.785*** (0.197)	
Parent Firm's Size	0.118 (0.098)	0.113 (0.097)	0.106 (0.097)	0.055 (0.104)	0.05 (0.103)	0.042 (0.103)
Constant	-31.76*** (5.695)	-20.196*** (2.898)	-32.242*** (5.503)	-27.826*** (6.14)	-20.796*** (2.672)	- (5.832)
N	1953	1953	1953	1274	1274	1274

¹³ Stata's fixed effects logit procedure does not allow calculating the interaction effect following Ai and Norton (2003).

Pseudo Rsq	0.51	0.51	0.51	0.46	0.45	0.45
Wald Chi2	336.2***	344***	294.8***	283.4***	270.8***	264.0***
Log Likel	-351.9	-354.6	-355.7	-323	-323.9	-326.4

*p<=0.1, ** p<=0.05, *** p<=0.01

FIGURE 1. Plots of interaction effects and their z statistics for specifications (1)-(3) of Table 3 using Ai and Norton’s (2003) method.



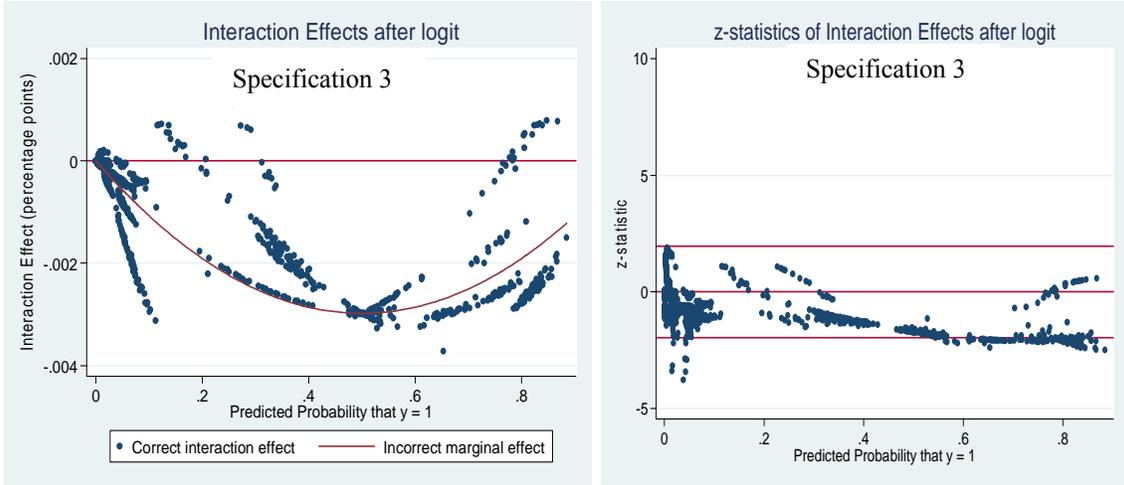
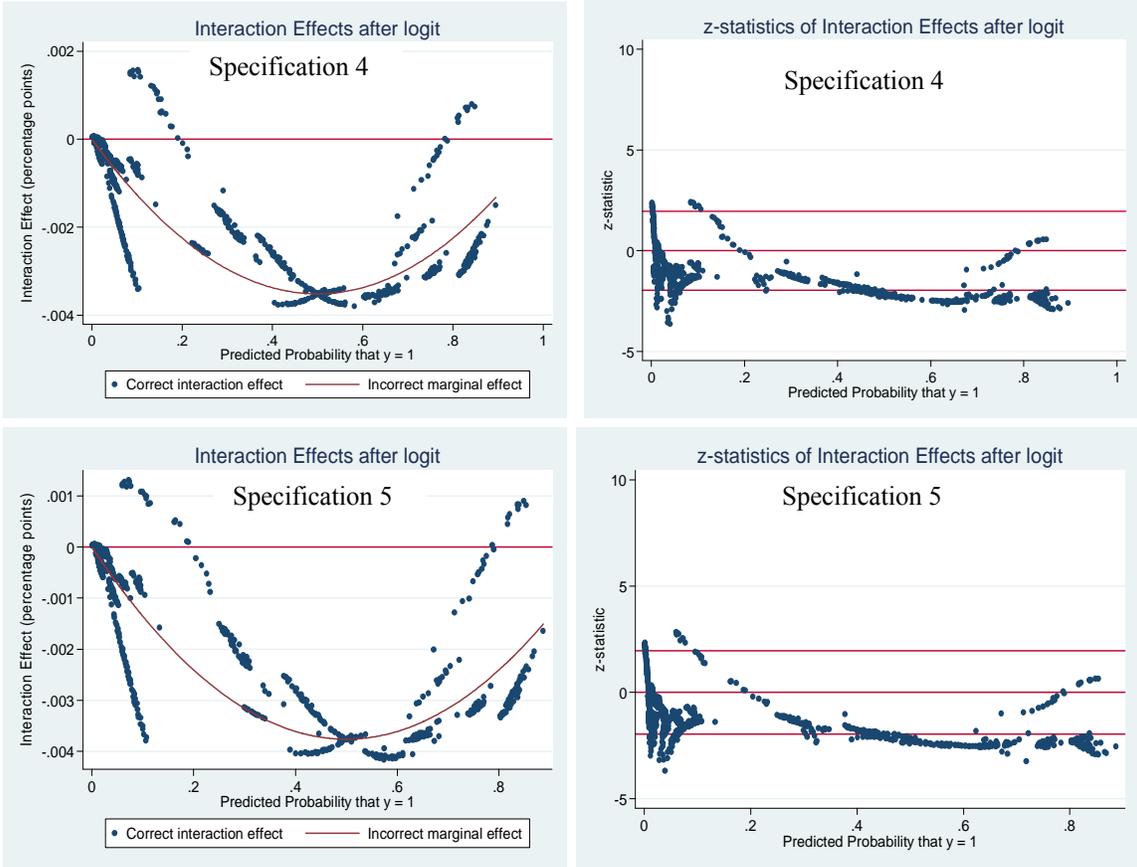
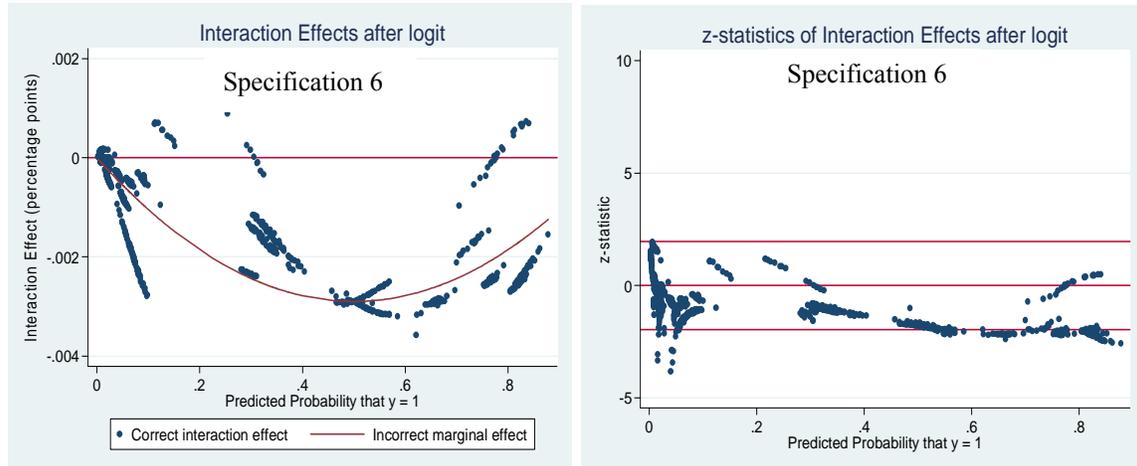


FIGURE 2. Plots of interaction effects and their z statistics for specifications (4)-(6) of Table 3 using Ai and Norton's (2003) method.





4.2. Heckman Two-Step Estimation

As an additional sensitivity check, we model a firm's FDI decision as a two-step decision, as described in section 3.

For more robust identification, it is recommended that exclusion restrictions be imposed, i.e. the selection equation contains an exogenous variable that is absent in the outcome equation (Cameron and Trivedi, 2009). The excluded variable should have a non-trivial explanatory power on the probability of investment but not on the volume of investment. Since the decision to invest or not is similar to an entry decision, a variable that proxies an entry barrier can serve as an exclusion restriction. Lambson and Jensen (1998) argue that capital costs are a large component of entry costs and use the book value of tangible fixed assets such as property, plant and equipment to proxy capital costs. We use the lagged ratio of tangible fixed assets over total assets as a proxy for

Entry Costs.¹⁴ A higher proportion of tangible fixed assets in total assets can increase entry costs and serve as a deterrent for new investments, including FDI. To make sure that this exclusion variable is valid, we included it also in the volumes equation. It was statistically insignificant. We also estimated both equations without the exclusion restriction. The results for our variables of main interest were unaffected. To save space, we report the two-step estimation results with the exclusion restriction.

Table 4 reports the two-step estimation results that exclude the parent's ownership concentration and its interaction with *SP*. We use the same sample of 93 UK parents that established majority owned JVs in at least one of the possible 21 destination countries. When transition host countries are excluded, then number of parents reduces to 91 and the number of host countries reduces to 14.

The lower part of the table shows the estimation results for the entry decision of a firm conditional on firm and host country specific variables. The upper part of the table shows the estimation results for the decision on how much to invest conditional on entry.

Host country's strength of legal shareholder protection (*SP*) has a significant and positive effect on the decision to enter - *SP* is positive and statistically significant across all specifications in the lower part of Table 4. This result is similar to the result of Table 2 from the logit model. In the entry (location) decision part of the Heckman model, the other host country control variables behave similarly to the ones from the logit model – *Presence* and *Taxes* are significantly negative, *Population* and *Governance* are significantly positive. GDP_{pc} is significant in the larger sample but insignificant in the smaller sample that excludes transition host countries. Firm level variable *Size* is

¹⁴ We also used the book value of tangible fixed assets (in natural logarithm) instead of the ratio of tangible fixed assets to total assets. Results were unchanged.

significant at 10% only in the larger sample. Our proxy for entry costs is negative but is significant at 5% or more in the smaller sample. In the larger sample, it is significant at 10% or 5%.

Regarding the decision on how much to invest conditional on entering a particular host country (the upper part of Table 4), *SP* is significant at 5% or 10% only in specifications that exclude the transition host countries. However, this significance disappears once parent's concentration and its interaction with *SP* are added to the model (see Table 5, upper part). On the other hand, parent's size is consistently significant and positive across all specifications – larger firms invest more. In contrast, parent's previous exposure to the host country has a significantly negative effect on the volume of investment. In the sample that excludes the transition host countries, larger population and better governance have a significantly positive effect on the volume of investment, while taxes have a significantly negative effect.

Finally, in Table 5 we repeat the same two-step analysis that include the parent's ownership concentration and its interaction with host country's strength of legal shareholder protection. As before, for the location (entry) decision (lower part of Table 5), host country's higher *SP* encourages FDI. However, *SP* seems less of a deterrent for firms with higher ownership concentration.¹⁵ The behavior of other controls in the location (entry) decision part is similar to those in Tables 2-4 discussed previously.

¹⁵ Unlike the Logit procedure, the Heckman procedure in Stata does not allow using Ai and Norton (2003) method of computing the interaction effect. However, in terms of statistical significance and signs, the logit results of Table 3 and the Heckman results in the lower part of Table 5 are very similar. We also observed from the logit part that when Stata's reported coefficients on the interaction terms were significant, the interaction coefficients calculated according to Ai and Norton (2003) were also significant (for a large number of observations). This leads us to believe that had we been able to calculate interaction effects in Table 5 using Ai and Norton method, the results would be similar to logit results.

For the volume of investment conditional on entry (upper part of Table 5), *SP*, parent's ownership concentration and their interaction are always insignificant. The behavior of other variables is similar to their behavior in Table 4.

TABLE 4. Heckman two-step estimation of model (2) without parent's ownership concentration and its interaction with the host country's level of legal shareholder protection. Cluster-robust standard errors are in parenthesis (clustering is done over the firms).

	(1)	(2)	(3)	(4)	(5)	(6)
<i>Dependent Var: FDI Volume (ln)</i>						
SP	0.152 (0.256)	0.169 (0.35)	0.151 (0.256)	0.456* (0.249)	0.494** (0.221)	0.438* (0.248)
Presence	-2.017** (0.843)	-2.215* (1.26)	-2.004** (0.814)	-3.247*** (0.583)	-3.256*** (0.558)	-3.193*** (0.648)
GDPpc	0.496 (0.878)		0.872 (0.803)	0.65 (0.83)		1.509** (0.753)
Population	0.273 (0.239)	0.238 (0.255)	0.368 (0.237)	0.473** (0.2)	0.411** (0.191)	0.661** (0.216)
Taxes	-0.066 (0.045)	-0.071 (0.056)	-0.059 (0.042)	-0.127*** (0.038)	-0.134*** (0.035)	-0.107*** (0.037)
Transition	0.911 (1.418)	0.073 (0.989)	0.649 (1.373)			
Governance	0.653 (0.498)	0.789 (0.57)		1.318*** (0.489)	1.565*** (0.425)	
Parent Firm's Size	0.482*** (0.128)	0.486*** (0.132)	0.472*** (0.128)	0.471*** (0.156)	0.469*** (0.155)	0.453*** (0.158)
Constant	-14.258 (11.342)	-9.52 (7.163)	-15.774 (11.089)	-23.286*** (9.746)	-17.159*** (4.329)	-27.442*** (9.75)
<i>Dependent Var: FDI Dummy</i>						
SP	0.399***	0.375***	0.426***	0.351***	0.347***	0.396***

	(0.065)	(0.063)	(0.062)	(0.06)	(0.059)	(0.057)
Presence	-2.08***	-2.089***	-2.078***	-1.969***	-1.968***	-1.976***
	(0.141)	(0.14)	(0.141)	(0.136)	(0.137)	(0.135)
GDPpc	0.452**		0.577***	0.081		0.289
	(0.205)		(0.2)	(0.234)		(0.214)
Population	0.532***	0.465***	0.581***	0.517***	0.511***	0.585***
	(0.088)	(0.073)	(0.088)	(0.078)	(0.074)	(0.078)
Taxes	-0.073***	-0.072***	-0.07***	-0.079***	-0.08***	-0.073***
	(0.013)	(0.012)	(0.012)	(0.012)	(0.012)	(0.011)
Transition	-0.127	-0.829***	-0.302			
	(0.394)	(0.194)	(0.386)			
Governance	0.313***	0.384***		0.405***	0.423***	
	(0.103)	(0.102)		(0.101)	(0.102)	
Parent Firm's Size	0.096*	0.097*	0.088*	0.08	0.08	0.069
	(0.051)	(0.051)	(0.05)	(0.05)	(0.05)	(0.049)
Entry Cost	-0.392*	-0.391**	-0.398*	-0.334***	-0.334***	-0.349**
	(0.21)	(0.202)	(0.212)	(0.133)	(0.132)	(0.156)
Constant	-15.44***	-10.111***	-15.813***	-11.469***	-10.613***	-12.606***
	(3.211)	(1.384)	(3.125)	(3.033)	(1.182)	(2.855)
N	1953	1953	1953	1274	1274	1274
Uncensored	265	265	265	243	243	243
Wald Chi2	26.91***	24.62***	26.67***	88.05***	89.12***	78.45***

*p<=0.1, ** p<=0.05, *** p<=0.01

TABLE 5. Heckman two-step estimation of model (2) without parent's ownership concentration and its interaction with the host country's level of legal shareholder protection. Cluster-robust standard errors are in parenthesis (clustering is done over the firms).

	(1)	(2)	(3)	(4)	(5)	(6)
<i>Dependent Var: FDI Volume (ln)</i>						
SP	0.233	0.268	0.204	0.682	0.716	0.602
	(0.486)	(0.6)	(0.468)	(0.482)	(0.48)	(0.643)
Concentration	0.048	0.05	0.039	0.095	0.092	0.073
	(0.093)	(0.099)	(0.09)	(0.09)	(0.094)	(0.104)
SP_Conc	-0.002	-0.003	-0.001	-0.01	-0.01	-0.007
	(0.016)	(0.017)	(0.016)	(0.016)	(0.017)	(0.019)
Presence	-2.172**	-2.345*	-2.156***	-3.27***	-3.284***	-3.223***
	(0.879)	(1.222)	(0.838)	(0.681)	(0.644)	(0.916)
GDPpc	0.647		1.019	0.845		1.59**
	(0.889)		(0.799)	(0.811)		(0.747)
Population	0.257	0.203	0.357	0.46**	0.357*	0.62**
	(0.248)	(0.245)	(0.243)	(0.217)	(0.204)	(0.28)
Taxes	-0.062	-0.068	-0.055	-0.120***	-0.126***	-0.099***
	(0.044)	(0.053)	(0.042)	(0.038)	(0.036)	(0.039)
Transition	1.216	0.224	0.932			
	(1.326)	(0.929)	(1.283)			
Governance	0.667	0.86		1.265***	1.549***	
	(0.488)	(0.553)		(0.487)	(0.419)	
Parent Firm's Size	0.545***	0.548***	0.535***	0.539***	0.517***	0.504***
	(0.133)	(0.134)	(0.133)	(0.157)	(0.159)	(0.165)
Constant	-17.475	-11.295	-18.757	-27.46***	-18.792***	-29.916***
	(12.316)	(8.164)	(11.887)	(10.57)	(5.798)	(12.147)
<i>Dependent Var: FDI Dummy</i>						
SP	0.62***	0.606***	0.625***	0.555***	0.545***	0.573***
	(0.106)	(0.115)	(0.101)	(0.112)	(0.111)	(0.118)
Concentration	0.058***	0.061***	0.053***	0.055***	0.054***	0.048**
	(0.021)	(0.021)	(0.02)	(0.02)	(0.02)	(0.02)

SP_Conc	-0.01*** (0.004)	-0.01*** (0.004)	-0.009** (0.004)	-0.009** (0.004)	-0.008** (0.004)	-0.008** (0.004)
Presence	-2.095*** (0.141)	-2.103*** (0.141)	-2.091*** (0.14)	-1.987*** (0.142)	-1.984*** (0.141)	-1.989*** (0.141)
GDPpc	0.443** (0.206)		0.577*** (0.199)	0.089 (0.237)		0.297 (0.207)
Population	0.531*** (0.088)	0.466*** (0.074)	0.583*** (0.089)	0.533*** (0.081)	0.513*** (0.077)	0.59*** (0.081)
Taxes	-0.073*** (0.013)	-0.072*** (0.012)	-0.069*** (0.012)	-0.082*** (0.013)	-0.08*** (0.012)	-0.073*** (0.012)
Transition	-0.097 (0.385)	-0.784*** (0.192)	-0.281 (0.379)			
Gvoernance	0.332*** (0.107)	0.404*** (0.105)		0.449*** (0.106)	0.447*** (0.103)	
Parent Firm's Size	0.096* (0.051)	0.097* (0.053)	0.088* (0.05)	0.095* (0.05)	0.085* (0.051)	0.074 (0.05)
Entry Costs	-0.427** (0.207)	-0.428** (0.205)	-0.433** (0.211)	-0.362** (0.156)	-0.37** (0.167)	-0.401* (0.213)
Constant	-16.783*** (3.232)	-11.643*** (1.514)	-17.055*** (3.154)	-13.353*** (3.048)	-12.061*** (1.351)	-13.905*** (2.832)
N	1953	1953	1953	1274	1274	1274
Uncensored	265	265	265	243	243	243
Wald Chi2	40.91***	40.62***	42.34***	82.93***	84.44***	74.64***
Wald Test of Ind. Eqns.	6.9***	3.83**	7.77***	18.75***	16.02***	7.82***

*p<=0.1, ** p<=0.05, *** p<=0.01

5. Conclusion

Managers can pursue private benefits from investment decisions at the expense of shareholders. Strong legal shareholder protection or high ownership concentration can alleviate this problem. However, home country's strong shareholder protection may not easily travel to the host country, at least not for joint venture subsidiaries. Therefore, host country's level of shareholder protection may become relevant. Weaker legal shareholder protection in the host country may make it costlier for shareholders to monitor the subsidiary and hold managers accountable. This prospect may motivate the managers to invest in such environments in the pursuit of private benefits. However, the agency costs associated with such investments can increase too. The latter would tend to discourage such FDI.

We test this ex ante uncertain relationship between the FDI location choice and host country's level of legal shareholder protection for a sample of publicly quoted UK firms that undertook new investments in Continental Europe between 1998 and 2001. The absolute majority of our sample subsidiaries are majority owned joint ventures. We find that weak legal shareholder protection in the host country reduces the likelihood of FDI. This negative relationship, however, is weakened as the ownership concentration of the parent firm increases implying that parent's ownership concentration may be a substitute for host country's weak legal shareholder protection.

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APPENDIX

Table A1. Firm level Fixed Effects Logit estimation results of model (1). Firm level invariant variables are dropped. Specifications (2) and (4) exclude transition host countries.

	(1)	(2)	(3)	(4)
SP	0.799*** (0.119)	0.807*** (0.130)	1.065*** (0.178)	1.078*** (0.167)
SP_Conc			-0.012* (0.007)	-0.012** (0.006)
Presence	-3.862*** (0.349)	-3.745*** (0.355)	-3.84*** (0.345)	-3.727*** (0.351)
GDPpc	0.967*** (0.367)	0.677 (0.462)	0.941** (0.370)	0.644 (0.467)
Population	1.019*** (0.174)	1.081*** (0.183)	1.012*** (0.173)	1.075*** (0.182)
Taxes	-0.137*** (0.024)	-0.155*** (0.025)	-0.137*** (0.024)	-0.154*** (0.025)
Transition	-0.018 (0.781)		-0.006 (0.776)	
Governance	0.512*** (0.179)	0.658*** (0.198)	0.548*** (0.191)	0.699*** (0.213)
N	1953	1274	1953	1274
Pseudo Rsq	0.57	0.51	0.57	0.51

Wald Chi2	220***	172.5***	260.8***	191.2***
Log Likel	-231.4	-202.5	-230.5	-201.7

*p<=0.1, ** p<=0.05, *** p<=0.01

Table A2. Logit estimation results of model (1) for the large sample that includes parents with majority owned joint venture subsidiaries as well as parents with minority owned and wholly owned subsidiaries. Cluster robust standard are reporting in parenthesis (clustering is done over the firms). Specifications (2) and (4) exclude the transition host countries.

	(1)	(2)	(3)	(4)
SP	0.763*** (0.108)	0.727*** (0.116)	1.05*** (0.167)	1.03*** (0.176)
Concentration			0.062** (0.031)	0.066** (0.033)
SP_Conc			-0.012** (0.006)	-0.013** (0.006)
Presence	-4.162*** (0.318)	-4.065*** (0.318)	-4.15*** (0.317)	-4.056*** (0.318)
GDPpc	0.864** (0.346)	0.545 (0.404)	0.839** (0.348)	0.515 (0.408)
Population	0.946*** (0.154)	0.935*** (0.156)	0.945*** (0.155)	0.935*** (0.157)
Taxes	-0.153*** (0.02)	-0.166*** (0.019)	-0.154*** (0.02)	-0.167*** (0.019)
Transition	-0.368 (0.699)		-0.414 (0.697)	
Governance	0.59*** (0.164)	0.759*** (0.183)	0.606*** (0.169)	0.777*** (0.189)

Parent Firm's Size	0.136 (0.086)	0.081 (0.086)	0.128 (0.085)	0.074 (0.086)
Constant	-27.75*** (5.259)	-24.37*** (5.648)	-28.98*** (5.308)	-25.68*** (5.7)
<hr/>				
N	2289	1526	2289	1526
Pseudo Rsq	0.51	0.46	0.52	0.46
Wald Chi2	301.3***	270.8***	307.0***	268.1***
Log Likel	-421.4	-390.6	-419.9	-389.1

*p<=0.1, ** p<=0.05, *** p<=0.01

Correlation Matrix

	FDI (dummy)	lnVolFDI	SP	Population	GDPpc	Governance	Taxes	Transition	Concentration	Conc.x SP	Firm Size	Entry Costs	Presence
FDI (dummy)	1												
lnVolFDI	0.8288	1											
SP	0.0462	0.0172	1										
Population	0.2092	0.1737	-0.278	1									
GDPpc	0.2202	0.1749	-0.067	0.0389	1								
Governance	0.2596	0.213	0.0949	0.2345	0.7552	1							
Taxes	0.1331	0.1144	0.1368	0.544	0.2602	0.3467	1						
Transition	-0.2421	-0.1902	0.0246	-0.2154	-0.901	-0.7513	-0.413	1					
Concentration	-0.0458	-0.0181	0	0	0	0	0	0	1				
Conc.x SP	-0.0275	-0.0132	0.4274	-0.1189	-0.029	0.0406	0.059	0.0105	0.8873	1			
Firm Size	0.0842	0.1289	0	0	0	0	0	0	-0.0718	-0.0637	1		
Entry Costs	-0.0238	-0.0061	0	0	0	0	0	0	0.0971	0.0862	0.2373	1	
Presence	-0.6222	-0.4923	0.0652	-0.3027	-0.252	-0.2839	-0.246	0.2747	0.0882	0.1055	-0.1189	0.0301	1