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Host Country Cultural Influences on Foreign Direct Investment

Abstract and Key Results

■ This paper provides a novel perspective towards understanding the influence of host country culture on the location choices of foreign firms. We argue that host country cultural variables: uncertainty avoidance and trust, influence the location choices of foreign firms such that foreign firms prefer to invest in nations with (1) low levels of uncertainty avoidance and (2) high levels of trust.

■ In addition to direct effects, we hypothesize that uncertainty avoidance moderates the relationship between host country trust and levels of foreign direct investment (FDI) such that the relationship between trust and FDI becomes weaker, as uncertainty avoidance increases.

■ The results in a sample of 43 nations are supportive of the hypothesized main effect of uncertainty avoidance and the moderating effects, and partially supportive of the main effect of trust on FDI, after controlling for economic, human capital, and governance infrastructure variables.

Key Words

Host Country, Culture, Location Choices, Foreign Direct Investment, FDI

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Introduction

Foreign direct investment (FDI) is a "long term commitment to a business endeavor" (UNCTAD 1998, p. 90) by foreign firms in a host country. Between 1990 and 2000, FDI grew from $200 billion to $1.3 trillion, and foreign affiliates currently account for ten percent of the world GDP (UNCTAD 2001, 2002). Yet, despite the significant growth in FDI, firms often face difficult choices regarding the location of the FDI (Dunning 1998). Firms seeking to invest in foreign countries are typically motivated to invest in nations with favorable economic, institutional, and regulatory conditions. In addition, foreign firms may be attracted to certain host country cultural characteristics (Dunning 1998). Yet surprisingly, the influence of host country culture on FDI has seldom been tested in a large sample of nations. In this paper, we seek to advance the understanding of the influence of host country national culture in shaping the location choices of foreign firms. Specifically, we address the question: Does host country national culture (i.e., uncertainty avoidance and trust) influence the location decisions of foreign firms?

We suggest that firm preferences for a particular national culture, in aggregate, are manifested in the total FDI a host country receives. Specifically, we argue that countries with low levels of uncertainty avoidance and high levels of trust are more attractive destinations for foreign firms. In addition to the main effects, we also focus on the interactive effects of uncertainty avoidance and trust on FDI. Because these cultural values underlie business practices (Hofstede 2001), they are potentially parsimonious explanations for cross-national differences in actual FDI inflows, which are not attributable to economic, institutional, policy-based, and regulatory factors.

Our approach to identifying the host country cultural influences on FDI has the potential of making several important contributions. Unlike past research on the determinants of FDI, we do not limit ourselves to FDI inflows into a host country from firms located in one specific or a limited group of countries, but consider the total sum of FDI a country receives with a view to understand the influence of national culture on the overall patterns of FDI. In addition, we focus on specific cultural characteristics (uncertainty avoidance and trust) of a host nation rather than focus on cultural distance, broadly defined as the extent to which cultures are similar or different (Shenkar 2001). Past research on the cultural determinants of FDI has primarily used cultural distance as the explanatory variable (Loree/Guisinger 1995, Jones/Teegen 2001). Shenkar (2001) concluded that FDI research involving cultural distance suffered from both conceptual and methodological shortcomings and had produced inconsistent findings. In particular, the culture distance concept makes an "invalid assumption of equivalence" (Shenkar 2001, p. 525) wherein the dimensions of culture are treated equally thereby ignoring the conceptually significant and meaningful effects of specific cultural dimensions (Hofstede 1989, Shenkar 2001).

For our study, we chose to focus on the specific cultural characteristics of nations (i.e. host country levels of uncertainty avoidance and trust) in influencing FDI decisions of foreign firms. In doing so, we also moved beyond the dimensions of culture developed by Hofstede and his colleagues to highlight the relationship between host country trust and FDI inflow.

Our paper also seeks to advance the concept of value trumping, the idea that in "specific cultural context, certain cultural values may take precedence over others" (Osland et al. 2000 p. 65). Specifically, we demonstrate empirically the rationales of value trumping by operationalizing them in the forms of interactive effects of cultural variables. In particular, we suggest that in the context of inward FDI, the cultural value of uncertainty avoidance trumps or takes precedence over the cultural value of trust.

As noted earlier, empirical research on the influence of host country culture on FDI has been very sparse, although scholars have argued for an impact of host country cultural factors on these foreign investments. In the next section, we present rationales for the direct effects of two host country cultural variables, uncertainty avoidance and trust, on the location decisions of foreign firms. At the heart of the paper, however, is our theorizing about, and testing of, the complex effects of host country national culture on FDI.

The Impact of Host Country Uncertainty Avoidance on FDI

Uncertainty avoidance, according to Hofstede (2001, p. 161), is "the extent to which the members of a culture feel threatened by uncertain or unknown situations." Members of high uncertainty avoidance nations feel a stronger threat from uncertain and unknown situations than do members of low uncertainty avoidance nations (Hofstede 2001). Because of stronger threat perceptions, high uncertainty avoidance countries (in comparison to low uncertainty avoidance countries) have a stronger need for rules, "absolute truths," and structure as well as a stronger degree of rigidity.

Several processes (attitudes toward the unknown, attitudes toward competition, preference for formalized contracts and structures, and the nature of rules and regulations) underlie the potential effects of uncertainty avoidance on the investments by foreign firms in a country. In high uncertainty avoidance nations, feelings of "what is different, is dangerous" (feelings that may be associated with ethnocentrism) (Hofstede 1999, p. 41) may create additional barriers that potential foreign investors have to overcome. These additional barriers may result from "discrimination by government, by consumers, and by suppliers" (Hymer 1976, pp. 34 et seq.). These barriers may put foreign investors at a disadvantage relative to local investors, potentially making them reluctant to invest (cf. Doney et al. 1998). Moreover, in

high uncertainty avoidance countries, general attitudes toward competition are more negative than they are in low uncertainty avoidance countries (Jones/Teegen 2001). Thus, any new competition that foreign investors bring may not be welcome in high uncertainty avoidance nations.

In combination with negative attitudes toward the unknown (including foreigners), these negative attitudes toward competition may enhance the "liability of foreignness" (Hymer 1976). Specifically, the theory of multinational enterprises (Dunning 1993, Caves 1996) emphasizes the additional costs investors face when doing business in foreign nations. This is often referred to as a liability of foreignness (Hymer 1976, Miller/Parkhe 2002, Zaheer 1995). Zaheer (1995), defines liability of foreignness as "the costs of doing business abroad that result in a competitive disadvantage for an MNE subunit ... broadly defined as all additional costs a firm operating in a market overseas incurs that a local firm would not incur." Hymer (1976, pp. 34 et seq., emphasis added) suggests that the liability arises from "... the fact that in given countries, foreigners and nationals may receive *very different* treatment." The higher liability of foreignness in high uncertainty avoidance nations may put foreign firms at a greater disadvantage (relative to local firms) and deters FDI. By contrast, lower liability of foreignness in low uncertainty avoidance nations, may reduce the relative disadvantage of foreign firms, and facilitates FDI.

Furthermore, in high uncertainty avoidance nations, relative to low uncertainty avoidance nations, the emphasis on rigid structures and the preference for extensive written rules (Hofstede 2001) discourages foreign investors. Specifically, foreign firms may have to incur considerable costs to acquire such information (Hymer 1976) while local investors, because of the advantage of greater localized and tacit knowledge in managing the bureaucratic complexities, may have to incur relatively lower costs. Further, researchers (e.g., Porter et al. 2000), suggested that Japan's lower attraction for FDI, at least partially, results from formal rules that may often deter foreign competition. Taken together, the above described processes lead us to hypothesize:

Hypothesis 1. Higher level of host country uncertainty avoidance is associated with lower inward FDI.

The Impact of Host Country Trust on FDI

While high levels of host country uncertainty avoidance may deter foreign investors from making foreign investments, host country trust may act as a magnet for FDI (e.g., Globerman/Shapiro 2002, 2003) as FDIs are based on relationships with foreigners in a host country and trust is a critical determinant for the formation, de-

velopment, and performance of business relationships. Below, we present, in greater detail, the rationales for the positive effects of host nation trust on location decisions of foreign investors.

Following Fukuyama's (1995, p. 26) definition, we define trust as the expectation of "regular, honest cooperative behavior" within a society. This trust stands for the approach that members of a society take in forming relationships. The members of a high-trust society view others as trustworthy, and in interactions with others they see less of a need to control and check the other party's behaviors than do members of a low-trust society. Because inter organizational relationships are in effect managed by individuals in organizations (Aulakh et al. 1996, Bradach/Eccles 1989, Hosmer 1995), interpersonal trust (among individuals) also forms the basis of inter organizational trust (Dyer/Chu 2000, Hosmer 1995, Ring/Van de Ven 1994). Thus, high levels of interpersonal trust in a host country influence both trust at the individual and inter-organizational levels.

High levels of interpersonal trust in a society attract FDI because of several processes (spontaneous sociability and greater speed, reduced perceptions of opportunism, and lower monitoring costs). First, trust leads to "spontaneous sociability" (Fukuyama 1995, p. 29) and enables members of a society (and firms) to form new associations and cooperative relationships, even with previously unfamiliar partners (La Porta et al. 1997). Spontaneous sociability also enhances the speed of relationship formation. Moreover, because the "behavioral repertoires [in a high trust society] are based towards cooperation, rather than opportunism" (Hill 1990, p. 511), trust is associated with expectations of reduced opportunism by others (e.g., Bradach/Eccles 1989). Consequently, in high-trust societies, opportunism is less of a factor in inhibiting relationships. Furthermore, perceptions of monitoring costs are likely lower in high trust societies than in low trust societies. In combination, spontaneous sociability, greater speed in relationship formation, expectations of reduced opportunism, and perceptions of lower monitoring costs likely attract greater FDI. In addition to providing ex-ante attractions to foreign investors, trust also enhances the ex-post efficiency of FDI. In particular, trust enhances efficiency (Arrow 1974, Ouchi 1981) by lowering costs (i.e. monitoring costs and costs due to opportunistic behavior by local agents). Moreover, efficiency of FDI is greater in high trust nations because employees in high trust nations have an ability to "work together for common purposes in groups and organizations" (Fukuyama 1997). Consequently, trust may be positively associated with the effectiveness (Child 2001, Parkhe 1998, Wilkins/Ouchi 1983) and performance (Aulakh et al. 1996) of FDI.

The consequences of the positive linkages between host county trust and FDI performance are two fold: First, positive FDI performance likely generates more FDI from well-performing foreign firms. Second, and more importantly, positive FDI performance has an important signaling effect on other foreign investors. More specifically, positive performance informs other foreign firms of good investment opportunities that can be potentially exploited. Signaling or "investment stalking"

typically generates a wave of additional FDI into the host country (Dunning 1998, Liu 1998, Mody/Srinivasan 1998) as success breeds more investments not only from successful firms but also from other firms seeking new opportunities. Even when follower firms do not have information about prior success (of leader firms), such imitative or stalking actions may be fairly common, routine, and typical among foreign firms (Knickerbocker 1973, Flowers 1976). Specifically, in making location decisions, "herd instinct is strong among multinational firms" (Khanna et al. 2005) and even under conditions of uncertainty (e.g., lack of performance information), organizations may routinely engage in imitative behavior of following organizations that have shown the lead in making FDI (e.g., DiMaggio/Powell 1983). While noting the consistency and speed of such "herd behavior", Flowers (1976, see also Knickerbocker 1973) suggested that "herd behavior" among foreign firms is primarily motivated by the need among firms not to give their competitors any unchallenged advantage in a foreign country.

In sum, higher levels of host country trust, ex-ante, facilitates relationships and reduces perceptions of transactions costs and, thereby, attracts FDI. In addition, ex-post, higher host country trust may be associated with greater effectiveness and higher performance of FDI. Better performance and ease of forming relationships motivate firms to make new FDI investments in the country. In addition, indications of good performance (by early movers) signal to other organizations, the opportunities to make profitable FDI investments in these high trust nations. Even in the absence of specific knowledge of prior performance, follower firms are motivated to imitate prior foreign investment decisions of early mover firms (which more likely happen in high trust nations). Putting all the arguments together, we propose:

Hypothesis 2. Higher level of host country trust is associated with greater inward FDI.

The Impact of Uncertainty Avoidance on the Relationship between Trust and FDI

Earlier we argued that trust enhances the number, speed, efficiency and performance of business relationships as well as a country's attractiveness for FDI. Trust, however, is not unlimited. As Fukuyama (1999, see also Harrison 1985) stated, there is a "radius of trust" that defines the circle within which trust is granted. A country can be a high-trust country, but this trust may not necessarily extend to foreigners and international investors (Contractor 1990). We suggest that uncertainty avoidance is a marker of the radius of trust that affects its extension to foreigners. As explained in detail below, we hypothesize that uncertainty avoidance may prevent the exten-

sion of trust to foreigners and, hence, may be a moderator of the relationship between a country's level of trust and inward FDI.

As mentioned earlier, uncertainty avoidance may be associated with ethnocentrism. It is also associated with a high anxiety of, and low tolerance for, the foreign or the unknown. For example, in high uncertainty avoidance countries, foreigners are more likely to be considered threatening, as is evident in the dislike of locals to work for foreign managers (Hofstede 2001). For Japan, a high uncertainty avoidance country, Fukuyama 1995 (see also Shane 1994) noted that the radius of trust may not extend to foreigners. In low uncertainty avoidance countries, the extension of trust, however, may not exclude foreigners. The effects of a country's level of trust on inward FDI may be reduced, as the country's level of uncertainty avoidance increases.

The reason for the reduced extension of trust to foreigners in high uncertainty avoidance countries may lie in the discomfort that locals feel in interacting with foreigners (e.g., Hofstede 2001). When locals evaluate foreigners, these foreigners relative to other locals are less known and the interpretation of their motivations and behaviors appears more ambiguous. In high uncertainty avoidance countries, this ambiguity leads to enhanced levels of discomfort in dealing with foreigners. Greater discomfort ex-ante reduces spontaneity in the formation of relationships and ex-post may have negative performance implications. In addition, the procedures used to produce and regulate trust (Shapiro et al. 1992) vary across cultures (Doney et al. 1998, Triandis 1995) and may provide further explanation for the reduced extension of trust towards foreigners in high uncertainty avoidance cultures. For example, in Japan (a high uncertainty avoidance culture), mutual monitoring and societal and informal institutional sanctions such as social and economic ostracism and reputation penalties for the violators of trust (Hagen/Choe 1998) play a greater role in the regulation of trust. In particular, high UA nations are accustomed to such a system of mutual sanctions and are more distrustful of outsiders because such sanctioning and monitoring mechanisms are effective only for guaranteeing cooperation within the group (Yamagishi/Yamagishi 1994). Thus, in high uncertainty avoidance nations, host country nationals perceive greater vulnerability if they extend trust to foreigners relative to locals (Huff/Kelley 2003), and this reduces the inclination of locals to extend trust to foreigners. In summary, uncertainty avoidance favors the exclusion of foreigners from the radius of trust in high UA nations, even if general societal trust levels are high. As a result, UA reduces the effects of trust on FDI.

In addition, the likelihood of greater ethnocentrism in high UA nations may provide greater bond strength and higher levels of cohesion in a society. According to Fukuyama (1999), strong bonds in a country may "actually serve to *decrease* the degree to which members of that group are able to trust outsiders and work effectively with them." In other words, UA affects to whom trust is extended and high UA may make the extension of trust more exclusive. Hence, the positive relation-

ship between a host country's level of trust and FDI may be weaker, at higher levels of UA. More generally, one cultural value takes precedence over another cultural value as uncertainty avoidance trumps the value of trust in shaping the location choices of foreign investors.

In summary, in high uncertainty avoidance countries, independent of the country's level of trust, foreigners may be less likely to be the recipients of trust, reducing the role of trust for attracting foreign investments. In low uncertainty avoidance countries, however, the levels of discomfort in dealing with foreigners may be lower and do not affect the relationship between trust and FDI. We formally hypothesize:

Hypothesis 3. Uncertainty avoidance will moderate the relationship between trust and inward FDI such that this relationship becomes weaker, as uncertainty avoidance increases (or stated differently, that this relationship becomes stronger as uncertainty avoidance decreases).

Method

Data Sources and Sample

The data for the current study came from several sources: the World Investment Report (WIR) (UNCTAD 2001), the World Values Survey (Inglehart et al. 2000), the World Development Report (WDR) (World Bank 1998, 2001), the Human Development Report (United Nations 1998), the Economist Intelligence Unit (EIU) Country Profile Taiwan (Economist Intelligence Unit, Economist 1996-2001), the Government of Taiwan website, the data on governance indices (Kaufmann et al. 1999a, 1999b), and the studies on cultural dimensions by Hofstede (2001) and his colleagues. Complete data were available for 43 countries (see Table 1 for a list of the countries), which represented more than 90 percent of the world GNP. The sample consisted of 24 of the 30 OECD (Organization for Economic Cooperation and Development) countries and 19 other countries in Africa, Asia, Eastern Europe and Latin America.

Measures

Inward FDI

We used the 1998-2000 inward FDI index from the World Investment Report (WIR) (UNCTAD, 2001) to assess inward FDI. The WIR is a comprehensive source of information on investments in nations, published by the United Nations Conference

Table 1. List of Countries, Country Codes and Data used in Figure 1

S No.	Country Code	Country	FDI Inward Index 1998–2000	Uncertainty Avoidance	Trust
1.	ARG	Argentina	2.80	86.00	20.44
2.	AUS	Australia	0.90	51.00	40.05
3.	AUT	Austria	1.50	70.00	31.82
4.	BAN	Bangladesh	0.10	60.00	20.91
5.	BRA	Brazil	2.00	76.00	4.63
6.	BUL	Bulgaria	1.20	85.00	29.50
7.	CAN	Canada	2.80	48.00	53.08
8.	CHI	Chile	2.30	86.00	22.05
9.	CHN	China	0.90	30.00	56.31
10.	COL	Colombia	0.80	80.00	10.80
11.	CRO	Croatia	1.40	80.00	25.09
12.	CZE	Czech Republic	2.00	74.00	30.25
13.	DEN	Denmark	4.20	23.00	57.66
14.	ENG	England	3.80	35.00	36.67
15.	EST	Estonia	1.60	60.00	24.55
16.	FIN	Finland	3.70	59.00	55.77
17.	FRA	France	1.80	86.00	22.79
18.	GER	Germany	2.50	65.00	31.88
19.	HUN	Hungary	1.00	82.00	24.59
20.	IND	India	0.20	40.00	36.65
21.	IRL	Ireland	8.90	35.00	47.37
22.	ITA	Italy	0.40	75.00	35.30
23.	JPN	Japan	0.20	92.00	42.02
24.	KOR	South Korea	0.60	85.00	32.24
25.	MEX	Mexico	0.70	82.00	30.78
26.	NED	Netherlands	6.10	53.00	53.47
27.	NOR	Norway	2.40	50.00	65.18
28.	PAK	Pakistan	0.20	70.00	18.84
29.	PER	Peru	0.80	87.00	5.02
30.	PHI	Philippines	0.30	44.00	5.54
31.	POL	Poland	1.30	93.00	26.21
32.	POR	Portugal	0.80	104.00	21.67
33.	ROM	Romania	0.80	90.00	16.07
34.	RUS	Russia	0.20	95.00	34.22
35.	RSA	South Africa	0.30	49.00	22.50
36.	ESP	Spain	1.60	86.00	31.99
37.	SWE	Sweden	8.50	29.00	62.89
38.	SUI	Switzerland	2.50	58.00	39.80
39.	TPE	Taiwan	0.40	69.00	41.83
40.	TUR	Turkey	0.10	85.00	7.74
41.	USA	United States	2.30	46.00	43.50
42.	URU	Uruguay	0.30	100.00	21.64
43.	VEN	Venezuela	1.20	76.00	13.75

on Trade and Development (Nachum 1999). The inward FDI index is a ratio of a country's share in worldwide inward FDI relative to its share in GDP, employment and exports, averaged over a period of three years. Accounting for a country's relative economic size, the index assesses the relative performance of nations in attracting FDI or, in other words, is a "measure of 'revealed competitive advantage' in attracting FDI" (UNCTAD 2001 p. 41), which allows between-country comparisons. The value for our sample ranged from 0.1 (Turkey and Bangladesh) to 8.9 (Ireland) and the median was 1.20 with higher numbers indicating greater attractiveness.

Uncertainty Avoidance

To assess national levels of uncertainty avoidance, we relied on the studies of cultural dimensions by Hofstede (2001) and his colleagues on national cultures. A considerable body of research (e.g., Barkema/Vermeulen 1997, Erramilli 1996, Kogut/Singh 1988, Pan 2002) has indicated the usefulness of Hofstede's cultural dimension of uncertainty avoidance, for explaining between-country differences. The uncertainty avoidance measure is the average of survey responses to three questions relating to rule orientation (the extent to which members of a culture comply with rules), employment stability (the extent to which members of a cultures prefer long-term employment) and stress (the extent to which members of a culture report more stress and higher levels of anxiety). The values ranged between 23 (Denmark) to 104 (Portugal) and the median was 74 with higher scores indicating greater uncertainty avoidance.
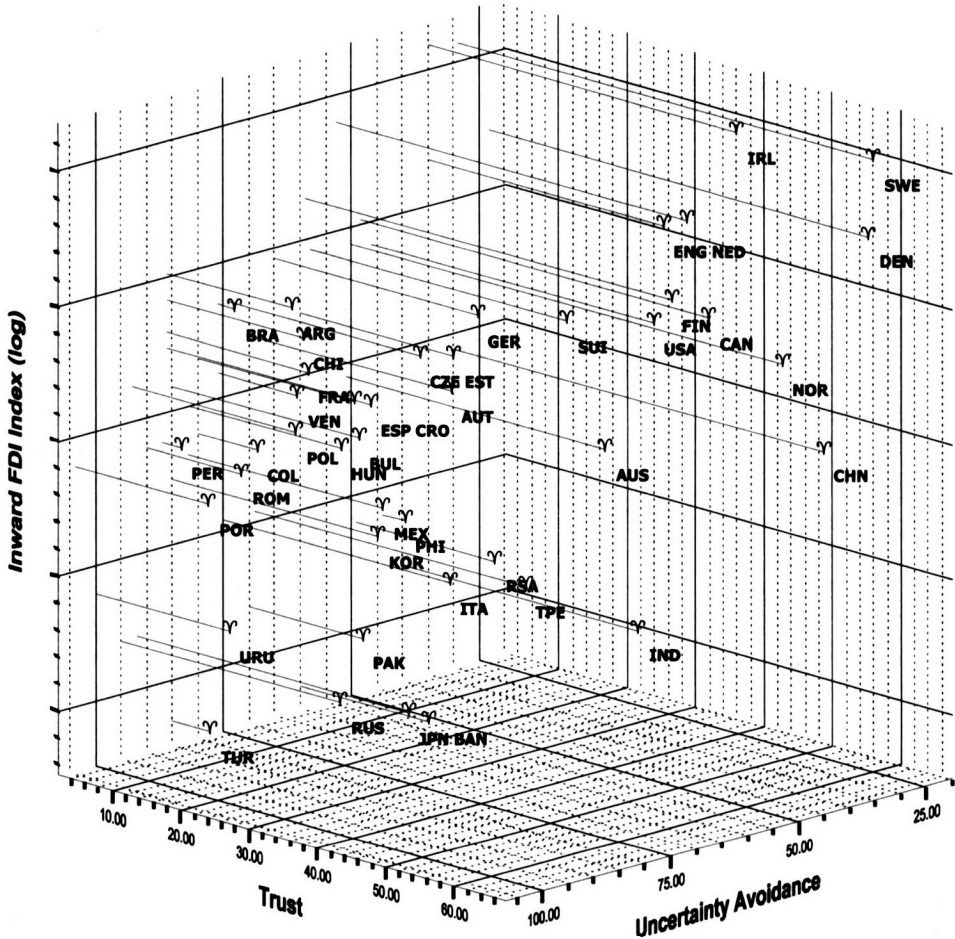
Trust

To assess levels of trust, we used the trust measure of the World Values Survey (WVS). As noted by Au and Cheung (2004, p. 1356), the WVS provides a "rich data set for international management study" (for a review of research that used the WVS, see Inglehart et al. 2000). The Institute of Social Research at the University of Michigan collected these data in several waves in more than 50 countries with per-country random samples of typically more than 1,000 respondents. We adopted the La Porta et al. (1996, see also Fisman and Khanna 1999) operational definition of country-level trust as the percentage of respondents in a country who responded favorably to the question that most people can be trusted and that one does not have to be too careful in dealing with people. Research (La Porta et al. 1996, Knack/ Keefer 1997) has shown that this measure gauges general levels of trust as opposed to trust placed in specific targets (e.g., family members and friends). In the current study, we averaged WVS trust scores from the 1991 and 1995-1998 waves. The

correlation between these two waves was 0.94 (p ≤ 0.001). For countries, where data were available for only one wave, we used these data. The trust scores ranged from 4.63 (Brazil) to 65.18 (Norway), and the median was 30.78 with higher scores indicate greater trust.

Figure 1 shows the scores of the 43 countries on the three variables inward FDI index, uncertainty avoidance, and trust. Inward FDI index is represented on the vertical axis and the spikes have been drawn to the vertical axis to indicate each country's

Figure 1. Data: Uncertainty Avoidance, Trust, and Inward FDI[1]

[1] Higher scores of trust (X-axis) indicate greater trust while higher scores of the dependent variable (Y-axis) indicate higher values of inward FDI index. Uncertainty avoidance (Z-axis) has been reversed such that points closer to the origin represent higher uncertainty avoidance while points farther from the origin indicate lower uncertainty avoidance. The 43 country labels below the data point are at clock positions between 4 and 5 P.M.

inward FDI index score. For the purpose of the graph, we used a logarithmic transformation of the inward FDI index. The predictors trust and uncertainty avoidance are graphed on the horizontal axes. The uncertainty avoidance scale is reverse scaled such that points closer to the origin indicate higher uncertainty avoidance.

Control Variables

Research on FDI has identified several host country factors that potentially influence location decisions of foreign firms. These factors include economic, regulatory, institutional, and human capital factors (for reviews see Dunning 1993, Caves 1996, Globerman/Shapiro 1999). Consequently, in our research we control for the effects of each of these factors.

Economic factors that potentially influence the location choices of foreign firms include (a) the level of economic development in the host nation (Reuber et al. 1973, Loree/Guisinger 1995) (b) host country economic growth (Anand/Kogut 1997) and (c) the size of the host country economy (Globerman/Shapiro 2003). We controlled for the level of economic development using two alternate and related measures: logarithm of per capita GNP and a country's human development index (HDI) (cf. Globerman/Shapiro 2002). The HDI was developed by the United Nations as a more comprehensive alternative to per capita GNP. The HDI is composed of three measures, namely per capita GDP and two measures of human capital that indicate cross-national differences in levels of education and life expectancy. The measures logarithm of per capita GNP and HDI were, as expected, highly correlated ($r = 0.94$); and the pattern of results did not vary using either measure of economic development. Here, we report the results with HDI as the broader indicator of economic development. In addition to the level of economic development, we also controlled for the national economic growth using the host nation's average economic growth over a ten-year period. In addition, as stated earlier, the dependent variable, the inward FDI index, indicates the FDI attractiveness of a nation after accounting for the relative economic strength and size of the country (UNCTAD 2001). That is, the index includes controls for a country's GDP, employment, and exports, which are broad and readily comparable indicators of relative economic size and strength (UNCTAD 2001).

In addition to economic and related (i.e., human capital) variables, on the basis of our review of FDI antecedents, we controlled for the quality of the governance structure (Loree/Guisinger 1995). Governance structure in a country may not only directly influence the decisions of foreign investors, but the presence of high quality institutions in a country may also generate high levels of trust. More specifically, trust (e.g., between host country firms and foreign investors) may potentially arise due to presence of strong legal institutions and efficient protection of property rights in the host nation. Thus, controlling for the effects of institutional arrange-

ments will help us delineate the effects of trust based in the host country culture from trust that may be attributed to the presence of high quality institutions in a country. Hence, in our paper, we control for the effects of host country institutional arrangements, using the comprehensive measures developed by Kaufmann and his colleagues (see Kaufmann et al. 1999a, for a detailed list of data sources Kaufman et al. 1999b). Their measures include six indices of (1) political stability (2) rule of law (3) corruption (4) regulatory environment (5) political freedom and (6) government efficiency and effectiveness. The six indices are highly interrelated, and so, following the lead of Globerman and Shapiro (2002, 2003), we calculated a single governance infrastructure score for each country using principal component analysis. As expected, a single factor explained 87 percent of the total variance in the measures. We labeled this factor quality of governance infrastructure index. We used this factor score to control for the quality of governance infrastructure.

In sum, we controlled for the key economic, human capital and governance infrastructure measures, which influence the FDI attractiveness of nations. While our list of control variables may not be exhaustive of all potential determinants of FDI, it is plausible to argue that it captures the key factors that are relevant for FDI research involving a cross-section of nations (e.g. Globerman/Shapiro 2002).

Results

Descriptives and Correlations

Table 2 shows the means, standard deviations, and intercorrelations of the variables. Consistent with Hypothesis 1, uncertainty avoidance correlated negatively with the inward FDI index. Consistent with Hypothesis 2, trust was positively associated with the inward FDI index.

Main Analyses

Table 3 shows the beta coefficients, their standard errors, variance inflation factors (VIF) and changes in R^2 for the hierarchical multiple-regression analyses (e.g., Cohen/Cohen 1983) with the inward FDI index as the dependent variable. Because of the high correlations among some of the study's variables, multicollinearity posed a potential problem because it increases the sensitivity of the statistical estimates to the data. The VIF (see Table 3), however, did not exceed the threshold of 10 (Studenmund 1992) or a more conservative 5.3 (Hair et al. 1998), indicating that multicollinearity was present, but was not a severe problem in the regression analy-

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Table 2. Means, Standard Deviations, and Intercorrelations of Variables

Variables	Means	SD	1	2	3	4	5	6	7	8	9	10	11	12
Dependent														
1. Inward FDI Index	1.82	2.00												
Economic and Human Capital Variables														
2. Per Capita GNP (log)	8.81	1.35	0.50											
3. (HDI) Human Development Index[8]	0.82	0.12	0.48	0.94										
4. Economic Growth	2.77	2.85	0.10	-0.10	-0.12									
Governance Infrastructure Variables														
5. VOICE[1a]	0.69	0.78	0.49	0.78	0.72	-0.19								
6. STAB[2a]	0.57	0.85	0.54	0.76	0.75	-0.06	0.81							
7. GOV[3a]	0.88	1.02	0.57	0.85	0.79	0.14	0.78	0.81						
8. REG[4a]	0.82	0.52	0.57	0.77	0.78	0.10	0.73	0.73	0.85					
9. LAW[5a]	0.81	1.01	0.56	0.88	0.81	0.06	0.85	0.87	0.94	0.82				
10. GRAFT[6a]	0.86	1.17	0.63	0.86	0.77	0.05	0.83	0.83	0.95	0.82	0.97			
11. GII[7]	0.00	1.00	0.60	0.88	0.83	0.02	0.89	0.90	0.96	0.88	0.98	0.97		
Cultural Variables														
12. Trust	31.51	15.76	0.55	0.54	0.50	0.10	0.48	0.67	0.65	0.39	0.67	0.68	0.64	
13. Uncertainty Avoidance	68.12	21.32	-0.53	-0.15	-0.08	-0.29	-0.24	-0.28	-0.38	-0.24	-0.38	-0.44	-0.36	-0.59

N= 43. [a] indicates variables that are components of GII, the Governance infrastructure index. [1] Voice, political freedom and civil liberties (VOICE), [2] Political stability, terrorism and violence (STAB), [3] Measures of government effectiveness and efficiency (GOV), [4] The extent of regulation and market openness, including tariffs and import controls (REG), [5] The rule of law, crime, contract enforcement and property rights (LAW), [6] The level of graft and corruption in public and private institutions (GRAFT), [7] The governance infrastructure index (GII) is calculated as the principal component factor score of governance indices VOICE, STAB, LAW, GRAFT, REG and GOV. [8] The HDI data is not available for Taiwan and has been estimated on the basis of 1997 HDI ranking for Taiwan provided by Government of Taiwan (Directorate General of Budget, Accounting, and Statistics). Information is available online at www.taiwanheadlines.gov.tw.

Notes: Correlations ≥ 0.30 or ≤ -0.30 significant at p ≤ 0.05.

Table 3. Beta Coefficients, Standard Error, VIF and Changes in R2 with Inward FDI Index as the Criterion

Variables	Beta	Standard Error	VIF	Change in R^2
Step 1				
Human Development Index (HDI)	0.00	0.25	3.35	
Economic Growth	0.09	0.13	1.06	
Governance Infrastructure Index	0.60*	0.23	3.30	0.37***
Step 2				
Trust	0.06	0.19	2.35	
Uncertainty Avoidance (UA)	-0.39*	0.19	2.00	0.12*
Step 3				
Trust X UA	-0.40*	0.14	1.51	0.11**
Overall R^2				0.61***

N = 43.   * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

sis. To further assess the sensitivity of the correlation and regression coefficients to the data used, we recomputed the analyses using the bootstrap method, which provides empirical (in contrast to statistical) parameter estimates. The results of these bootstrap analyses reproduced the pattern of findings reported here.

Step 1 contained the control variables human development index, governance infrastructure, and economic growth. The beta coefficients for economic growth and human development index were not significant, whereas, consistent with past research, the beta coefficient for governance infrastructure was significant. The control variables explained 37 percent of the variance in inward FDI index ($p \leq 0.01$).

In addition to the control variables entered in Step 1, Step 2 included the independent variables uncertainty avoidance and trust. In support of Hypothesis 1, the beta coefficient for uncertainty avoidance was significant. The beta coefficient for trust was not significant (controlling for the variables entered in Step 1). Follow-up analyses, indicated that trust, when entered separately in Step 2 (after the control variables), explained variance in the inward FDI index above and beyond the control variables with R^2 change of .05 ($p \leq 0.10$). Overall, hence, the support for Hypothesis 2 was mixed. Taken together, the predictors uncertainty avoidance and trust avoidance explained 12 percent of the variance in the inward FDI index above and beyond the control variables.

Finally, Step 3, in addition to all the variables introduced in the 2 prior steps, contained the Trust X Uncertainty Avoidance interaction term. This step produced support for Hypothesis 3 that uncertainty avoidance would moderate the relationship between trust and FDI attractiveness such that this relationship became weaker, as uncertainty avoidance increased. The beta coefficient for the centered Trust X

Uncertainty Avoidance interaction term was significant; and the interaction term explained a unique 11 percent ($p \leq 0.01$) of the variance in inward FDI index above and beyond the variables entered in the previous steps. Follow-up analyses showed that, consistent with Hypothesis 3, trust was associated with inward FDI index in low uncertainty avoidance countries ($r = 0.59$, $p < 0.01$), but not in high uncertainty avoidance countries ($r = -0.17$, *ns*). Figure 2 illustrates the interaction.

Figure 2. Uncertainty Avoidance X Trust Interaction Plot
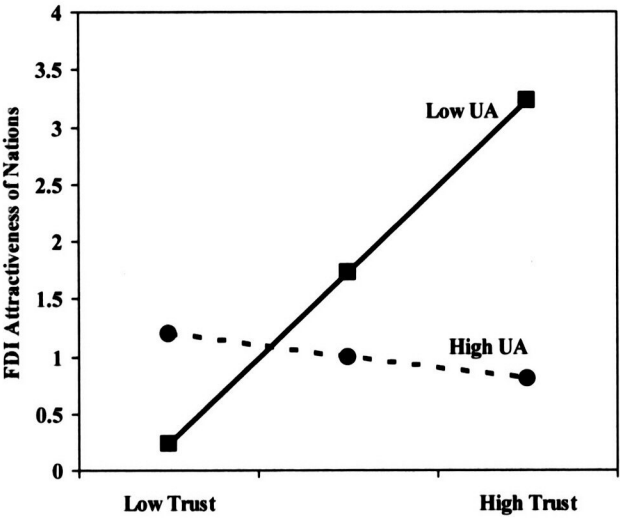
Discussion

Our study is among the first to empirically demonstrate the influence of host country culture on the location choices of foreign firms. As hypothesized, we found support that foreign firms prefer to locate investments in countries with lower levels of uncertainty avoidance. We found mixed support for a direct effect of host country trust on location decisions of foreign firms. Trust predicted FDI inflows only when entered independent of uncertainty avoidance. The most important finding is that of an interaction effect of uncertainty avoidance and trust on FDI inflows: As hypothesized, uncertainty avoidance moderated the positive relationship between a country's level of trust and FDI, such that this relationship became weaker, as uncertainty avoidance increased. It is noteworthy that these host country cultural factors affected inward FDI after controlling for economic, human capital, institutional, and regulatory antecedents of FDI.

Theoretical Implications

Direct and Interactive Effects of Cultural Variables

The main focus of our study was to examine the influence of host country cultural factors on the location decisions of foreign firms. We find clear evidence that host country culture does matter for foreign investors. Specifically, our findings reveal both direct as well as interactive effects of cultural variables (uncertainty avoidance and trust) on the location choices of foreign investors. The findings of the moderating effects of uncertainty avoidance on the relationship between trust and FDI are consistent with the notion that increasing levels of uncertainty avoidance may narrow the radius of trust at the expense of out-groups (i.e., foreign investors). Hence, even in studies at the national level, understanding the effects of trust requires understanding the targets of trust (i.e., here understanding foreign business partners as out-group members). Our research adds to the work by others on trust in nations (e.g., Fukuyama 1999), who highlighted the importance of the radius of trust. Although our data may suggest the negative effect of a narrow radius of trust on a country's ability to attract foreign firms, we acknowledge that the effects of such a narrow radius of trust do not have to be uniformly negative. For example, a narrow radius of trust may increase the quality of relationships within the circle, such as those between domestic buyers and suppliers (cf. Dore 1987, Ouchi 1981).

The radius of trust represents one specific example of the interactive effects of cultural variables. Past research on the effects of cultural variables, in particular cultural dimensions (for extensive reviews, see Trompenaars 1993 and Hofstede 2001), has mostly investigated simple main effect models. This research has produced many insights, but the inclusion of interaction effects, as shown in our study, has the potential to enhance the explanatory power of cultural dimensions. Moreover, interaction models can better portray the complexity of cultural effects than can main effects models. One process that may underlie such interaction models is *value trumping* (Osland et al. 2000). Value trumping, according to Osland, Bird, Delano, and Matthew (2000), can explain cross-cultural paradoxes, where cultural dimensions appear to have contradictory effects or fail to explain behaviors. For our study, it is plausible to argue that in the context of the treatment of foreigners in business relationships, the values of uncertainty avoidance took precedence over the value of trust. As a result, we can explain the seemingly paradoxical finding that in some high-trust nations (e.g., Sweden) trust is associated with greater FDI, whereas in other high-trust nations (e.g., Japan) it is not.

In summary, allowing value trumping to guide the development of rationales for cultural effects on business decisions may help researchers to unpack and understand the influences of cultural variables beyond their effects on ownership structure that have been previously identified in international business studies (e.g., Kogut/

Singh 1988, Hennart/Larimo 1998). Rationales, which are based on the notion of value trumping, can then, as we have done here, be operationalized in the form of interactions.

Competitiveness of Nations

The findings that host country cultural variables affect location decisions of foreign firms suggest that host country culture may directly influence its competitiveness (cf. Dunning/Bansal 1997, van Den Bosch/van Prooijen 1992) by shaping a nation's ability to attract foreign firms. In addition to the direct effects, host country culture may also indirectly affect the competitiveness of nations because foreign firms enhance the levels of competition within a nation, thereby increasing the productivity of host country firms (Okamoto 1994, Porter 1998). Future research might specifically address the effects of culture on other facets of national competitiveness.

Practical Implications

Implications for National Policy Makers

National policy makers may view our findings as indicative of the cultural receptiveness or readiness of their nations for FDI. The findings inform decision makers that uncertainty avoidance and trust in isolation are not sufficient cultural ingredients for attracting FDI. Instead, those nations that have high levels of trust, combined with low levels of uncertainty avoidance (e.g., Ireland and China) appear to have the best cultural cards in the national "location tournaments" (Wheeler/Mody 1992) for FDI. Those nations that do not have these cards may need to consider compensatory measures, clearly understanding that cultural values are not easily changed. A first step might be awareness campaigns with national trade organizations and chambers of commerce, but also with potential foreign investors.

Implications for Managers

Researchers (e.g., Gratchev 2001) argue that global managers have to know and understand the countries in which their firms invest, just like they have to know and understand the industries in which their firms operate. On the basis of our findings, managers learn about the complex interplay of cultural factors that affect business relationships and subsequent decisions about international investments. Global

managers may leverage their understanding of the effects of value trumping (for a detailed discussion Osland et al. 2000) on FDIs to their advantage. For example, in those countries where high levels of uncertainty avoidance limit the radius of trust, managers may more strongly rely on local partners, although such partners may be harder to find in high UA nations. In those countries, they should also consider hiring local employees, who then should be responsible for managing the relationships in the host country.

Limitations and Directions for Future Research

Like all studies on differences in cultural dimensions across countries, our study has limitations. We acknowledge that interpretations of our findings must stay at the country-level, and take into account that within-country differences as well as the emerging sub-regional trends in FDI flows were ignored. Another limitation is that we use FDI flow data for a three-year period. Future research may consider using a combination of FDI stock data and FDI flow data over longer and different periods of time. Further while the research question in our research examined the influence of host country cultural variables, future research may focus on the influence of home country culture variables (e.g., investor trust and investor uncertainty avoidance) on FDI. One may also criticize the limited number of countries in our sample, although these countries make-up over 90 percent of the world economy. We do not have reason, however, to believe that our theoretical rationales are sample-specific, and we expect to reproduce our findings with other samples.

Conclusion

Our study is among the first that examine and demonstrate the main and interactive effects of host country cultural values on location decisions of foreign firms. Our findings clearly emphasize the important role host country culture may play in shaping FDI. In addition to the main effect of uncertainty avoidance and partial effect of trust on FDI, we built theoretical arguments for interactive effects of cultural variables on FDI, utilizing the notion that trust has a radius, which is reduced by uncertainty avoidance. Further, controlling for economic, human capital, and governance infrastructure variables, we indeed found that the effect of trust on FDI was greater, when uncertainty avoidance was low. Our study also contributes to the research on cultural values: To our knowledge, it is the first study that translated the notion of value trumping, according to which certain values can take precedence over others depending on the situation, into testable interaction hypotheses.

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