Journal of Financial Economics 102 (2011) 621–642

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Egalitarianism and international investment ☆

Jordan I. Siegel [a,*], Amir N. Licht [b], Shalom H. Schwartz [c]

[a] Harvard Business School, United States
[b] Interdisciplinary Center Herzliya, Israel
[c] Department of Psychology, Hebrew University in Jerusalem, Israel

ARTICLE INFO

Article history:
Received 19 September 2008
Received in revised form
4 November 2010
Accepted 1 December 2010
Available online 31 May 2011

JEL classification:
F21
F23
G32
G34
K22
Z13

Keywords:
Culture
Informal institutions
Social institutions
Egalitarianism
Cultural distance
International investment
Cross-listing
Foreign direct investment
Mergers and acquisitions

ABSTRACT

This study identifies how country differences on a key cultural dimension—egalitarianism—influence international investment flows. A society's cultural orientation toward egalitarianism is manifested by intolerance for abuses of market and political power and a desire for protecting less powerful actors. We show egalitarianism to be based on exogenous factors including social fractionalization, dominant religion circa 1900, and war experience from the 19th century. We find a robust influence of egalitarianism distance on cross-national flows of bond and equity issuances, syndicated loans, and mergers and acquisitions. An informal cultural institution largely determined a century or more ago, egalitarianism exercises its effect on international investment via an associated set of consistent contemporary policy choices. But even after controlling for these associated policy choices, egalitarianism continues to exercise a direct effect on cross-border investment flows, likely through its direct influence on managers' daily business conduct.

1. Introduction

Tell a financial economist that cultural distance affects investment and she may cringe. Although evidence obtained during the last decade no longer allows such a claim to be dismissed out of hand (e.g., Grinblatt and Keloharju, 2001; Sarkissian and Schill, 2004; Chan, Covrig, and Ng, 2005), the mechanisms that may engender these widely observed correlations remain poorly understood. Some proxies for cultural distance such as common language may provide a partial explanation as measures of friction on information flow. But when, in a related context, a measure of cultural distance based on bilateral score data from the Eurovision Song Contest is said to

☆ Comments and criticisms from Stijn Claessens, Mara Faccio, Mauro Guillen, Vit Henisz, Raja Kali, Bruce Kogut, Tarun Khanna, Adrianna Lohnes, Aldo Musacchio, Felix Oberholzer-Gee, Jan Svejnar, Eric Werker, and seminar participants at the ISNIE Annual Conference, the Institutions, Politics, and Corporate Governance Conference, the Harvard Business School International Seminar Series, the Harvard Business School International Research Conference, and the University of Arkansas are appreciated. We are grateful to Jong-sung You for sharing data on corruption indices and their determinants. Research funding from the Division of Research at Harvard Business School, the Harvard University Weatherhead Center for International Affairs, and Israel Science Foundation Grant No. 921/02-1 is gratefully acknowledged. The usual caveat applies.

* Corresponding author.
E-mail addresses: jsiegel@hbs.edu (J.I. Siegel), alicht@idc.ac.il (A.N. Licht), msshasch@mscc.huji.ac.il (S.H. Schwartz).

0304-405X/$ - see front matter © 2011 Elsevier B.V. All rights reserved.
doi:10.1016/j.jfineco.2011.05.010

robustly affect bilateral trade volumes (Felbermayr and Toubal, 2010), one may be justified in feeling discomfort. Such findings challenge one to advance a fuller, theory-driven account of the causal link between cultural distance and investment, and to present robust evidence for such relations.

To meet this challenge, we advance an analytical framework that draws on several disciplines. Culture in this framework stands for the foundational institutions of society—the system of values and beliefs that underlies more specific formal institutions and informal ones (North, 1990; Williamson, 2000). A central factor in every culture is its stance toward egalitarianism, defined as "the belief that all people are of equal worth and should be treated equally in society" (Schwartz, 2001, p. 65). This deep-seated institution addresses every society's need to guarantee responsible behavior that preserves the social fabric and induce people to manage their unavoidable interdependencies (Schwartz, 1994, 1999, 2004). Cultures vary in their orientation toward egalitarianism versus its conceptual opposite, hierarchy. The latter defines the unequal distribution of power, roles, and resources as legitimate and even desirable.

A culture's relative emphasis on egalitarianism implicates numerous aspects of life that involve the exercise of power and authority. Social scientists in various disciplines have recognized power as a universal, ubiquitous phenomenon and its social institutional regulation as a core issue of culture and societal organization (e.g., Bourdieu, 1973; Schwartz, 1994; compare Russell, 1938). The exercise of power and authority is particularly pertinent in the theory of the firm and corporate governance (Coase, 1937; Hart, 1995; see also Morck, 2008). Consistent with these views, we demonstrate below that egalitarianism relates to certain modes of use (or abuse) of political power and public office, (e.g., corruption). Egalitarianism is linked to corporate governance mechanisms addressing the agency problem in public companies—-through greater transparency and more stringent auditing as checks on agents' power. Egalitarianism associates with formal and informal institutions that support fairer competition in the marketplace through antitrust regulation that curbs excessive market power. More broadly, egalitarianism also associates with greater societal care for the weak through social safety nets that support the sick, elderly, and unemployed.

Our findings are in line with prior research showing that other laws, norms, and practices pertaining to firms' operations and finance tend to be consistent with the general level of cultural egalitarianism. For instance, egalitarianism is associated with regulatory restrictions on incentive pay meant to protect industrial workers (Siegel and Larson, 2009). Also, egalitarianism is linked to more attentive and considerate negotiation practices versus negotiation styles that include invoking one's superior power to extract gains from the other party (Brett and Okumura, 1998; Brett, 2001; Tinsley, 2001).

Entering a foreign market—be it through strategic or portfolio investment, or through equity or debt instruments—may entail entry into a very different institutional environment. Cultural distance—and in particular, egalitarianism distance—represents the degree of institutional (in)compatibility between the home and host markets. The greater the distance on egalitarianism between two countries, the lower the scope of investment between them is likely to be. This is because investors will require higher expected returns in order to compensate for the need to adjust to this new environment. As the distance on egalitarianism increases, assets may become more difficult to price, corporate governance practices may be less acceptable, firm stakeholders (lenders, employees, authorities, etc.), more difficult to deal with, subsidiaries' managements more difficult to control, and negotiations more likely to fail. Beyond a certain point, firms may decide that bridging this distance is not worthwhile.

We therefore expect the effect of egalitarianism distance to be more pronounced in investment modes that are more susceptible to cultural differences—specifically in mergers and acquisitions and syndicated loans versus issuances of bonds and equities. Relative to issuance of tradable securities, mergers and acquisitions and syndicated loans entail a much more intense interaction between the institutional environments—interactions that are less formatted in standard templates of prospectuses, involve more detailed and nuanced negotiations, and require ongoing monitoring by the acquirer or the lead bank.

Crucially, we do not refer to culture as an "unspecified residual" nor to cultural distance merely as a synonym for "otherness." Rather, we point to egalitarianism as a meaningful cultural orientation that is conceptually linked to investment, and to egalitarianism distance as a measure of institutional (in)compatibility. Analyzing the meaningful content of egalitarianism allows one to identify its potential antecedents. We identify three such antecedents: societal fractionalization, countries' dominant religion around 1900, and countries' war experience during the 19th century. These three factors together predict over half of the variance in the level of countries' cultural egalitarianism. Thus, although culture may respond to contemporary socioeconomic conditions, it also has a substantial, stable core.

We analyze international investment flows between country-pairs around the world in both cross-sectional and panel data for 1995–2008, covering bond and equity issuances, syndicated loans, and mergers and acquisitions (M&A). We find a strong negative effect of egalitarianism distance on this broad set of international investment flows. Specifically, we observe this effect when using the above antecedents of egalitarianism as instrumental variables—indicating that egalitarianism distance indeed decreases international investment. This egalitarianism effect is robust while using different regression methodologies. It is robust to an array of control variables including, in particular, measures of distance on investor legal rights and different legal origins. The findings remain robust in specifications with home and host country fixed effects as well as economic and institutional control variables that capture additional mechanisms that might influence international investment, including specific mechanisms related to egalitarianism. These findings are also robust to other proxies of cultural distance that