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The three pillars of institutional theory and FDI in Latin America: An institutionalization process

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Abstract

This paper describes the process of institutionalization and legitimization in countries in Latin America and its impact on organizational decision-making regarding inward foreign direct investment (FDI). It argues that institutionalization is a process that works through all three pillars—cognitive, normative, and regulative—and that this process can legitimize a host market for foreign investors. The study examines institutional reform in 16 Latin American countries using several indices of institutional change occurring between 1970 and 2000. Results indicate that institutional processes that legitimize more effectively through the cognitive and normative pillars (e.g. educational attainment, bilateral investment treaties, privatization, and political uncertainty) are better indicators of inward FDI than those that legitimize primarily through the regulative pillar (e.g. tax reform, trade reform, and financial account liberalization).

Keywords: Foreign direct investment; Institutionalization process; Latin America

1. Introduction

Although the relationship between organizational decision-making, foreign direct investment (FDI), and institutional theory has been widely studied, knowledge of this subject stems primarily from the economic version of "New Institutionalism" that focuses almost exclusively on economic efficiency (Mudambi & Navarra, 2002; North, 1990; Williamson, 1985). The international business community's understanding of this subject may be limited, however, inasmuch as all forms of institutions that manage human interactions via cognitive, normative, and regulative processes influence organizational decision-making (Scott, 1995). In fact, although Grosse and Trevino (2005) acknowledged that all three institutional pillars provide a basis for analysis when it comes to organizational decision-making and FDI, their research failed to incorporate either

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the cultural-cognitive or the normative dimensions. Failure to include the cognitive or normative pillars into models of FDI location leads to an incomplete understanding of the impact that institutions have on FDI decision-making.

The present study on FDI in Latin American corrects for this gap in extant literature and extends institutional theory in several ways. First, this study answers the call to develop a more comprehensive understanding of the institutional environment–FDI decision-making interface in developing economies (Hoskisson, Eden, Lau, & Wright, 2000). We develop such a model by incorporating all three pillars of institutional theory in a single model. Second, in contrast to the approach taken by Scott (1995) and Kostova (1997), we posit that institution building is a process and not a typology. Under this approach, we do not force institutional constructs that may influence behavior into categories such as cognitive, normative, or regulative. Rather, we theorize that these pillars represent the underlying processes that lead to institutional change, ultimately influencing firm-level organizational outcomes. Third, liberalization policies, market reforms, and inflows of FDI have varied considerably in Latin America, both cross-sectionally and longitudinally. As such, and in response to North (1990), who said that change is decidedly incremental, the present study examines the impact of institutionalization over an extended timeframe (31 years), thus allowing for the emergence of institutions. In summary, the objective of the current paper is to demonstrate that host country institution building is a process that works through all three pillars of institutional theory to affect foreign investors' perceptions of the host country as a potential production location.

1.1. FDI in Latin America

Latin America is a unique region with a long and varied history of FDI (Trevino, Daniels, & Arbelaez, 2002), often dating back to the nineteenth century (Behrman, 1974). Early FDI in the region was primarily export-oriented and driven by multinational enterprises (MNEs) seeking access to natural resources (Grosse, 1989). Governments in Latin America, often at odds with MNEs over policy issues, have had a pervasive influence on business, at times exerting significant regulative powers and enforcing them arbitrarily. This created sectors that excluded foreign companies or required them to compete against subsidized domestic firms.

Import substitution industrialization in the post WWII era led to a shift in FDI toward manufacturing for domestic consumption and further insulated the domestic economy from foreign competition (Biglaiser, 2006). Although the economies of most Latin American countries grew rapidly from the post WWII era until the 1980s, lack of international competition eventually set the stage for abrupt halts in economic growth. By prohibiting most imports, and by placing severe restrictions on FDI, governments in many Latin American countries created a non-innovative business climate. Compounding the problem, foreign exchange shortages became a crisis for many countries in the region in the 1980s because they could not generate sorely needed hard currency through the exportation of inferior products. These policies led to closed nationalistic economies and this continued in many countries until the late 1980s. This economic and institutional landscape led to capital flight and chronic foreign exchange shortages, and eventually to economic and institutional reform. Lacking hard currency in the 1980s, many governments in Latin America began to open up their markets in a return to export-oriented FDI, and many of the traditional roles of government were transformed (Thomas & Grosse, 2001). Governments in Latin America also have decentralized economic decision-making by shifting it from the state to the private sector, thus allowing market forces to drive competition.

Over the past several decades, Latin American countries' institutional profiles have changed dramatically and it has become accepted that the old model of state directed import substitution industrialization was unsustainable. The time period in which institutional reforms occur varies depending on the country under study, however. For example, while Chile's reforms began in the early 1970s, most reforms in the region slowed during the early 1980s, a period of debt crisis, and many other Latin American countries began increasing reform only after that period. Further, different types of institutional reforms began in different periods. "Trade reform and domestic financial liberalization were the first components to be widely adopted [in Latin America], with 11 countries reaching [a high level of reform] by 1990, and all but one of the rest reaching [a high] level by 1995. However, there is much less convergence and more variance in … privatization