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# The trend of foreign direct investment movement: Did unintended nation brand of legal-families play an instrumental role?

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## ABSTRACT

Combining the suggestion from Fan (2006) that a nation can have a brand image without deliberating efforts of nation branding and the work from Klerman et al. (2011) on Colonial History and effects on legal systems, we view that legal-systems could be an unintended nation brand that could instrumentally affect foreign direct investment (FDI) activities. We classify 193 countries according to their Colonial History or no-Colonial History into 5 legal-families. Applying Generalised Methods of Moments (GMM) on a set of panel data, our empirical evidence shows that legal-families play an instrumental role in explaining FDI activities. The paper opens up a new ground of research on 'unintended' nation brand of which the nation branding literature largely focus on designed-nation-brand, and on FDI area in which we introduce a new determinant in addition to the traditional determinants that have been reported in the FDI literature.

## 1. Introduction

Most literature on Nation Branding is on how a country or a place make some efforts to create a distinguished brand following a designed plan or strategies of the local government. The purpose of doing so is to make the places more attractive to businesses and tourists, and in turn contribute to the economic growth. The ways to create Nation or Place Brands are numerous. Some examples are: Switzerland creates a brand as an expert of science, research and education to attract investments from China (Schlegel, Jacot, & Fetscherin, 2011); Humborg (2010) explores how countries can use Democracy as nation brand.

However, there are some Nation or Place Brands that could be created *unintentionally* and naturally simply throughout the course of the historical development of a country or a place. One obvious example is a nation's culture that has been developing throughout the history with multiple factors that are hard to pin point what they are – things were just evolved in their own ways. Brach (2010) discusses this type of nation brand with examples from Switzerland, Sweden, Nigeria, and Poland. Fan (2006) suggests that a nation can have a brand image without deliberating efforts of nation branding. This is an interesting and powerful insight – nation brand can be created naturally even though there was no effort to create one.

In this paper, we are particularly interested in how the Colonial History of some countries have created *unintended* brands through the heritage (good or bad) of legal systems. It is not the purpose or scope of

this paper to make a judgement on the Colonial History. Instead, we argue that the Colonial History and the related Legal systems can form an unintended nation brand which in turn can play an instrumental role of attracting foreign direct investments (FDI).

We use the data from 193 countries and apply System Generalised Methods of Moments (GMM) on a set of panel data. The findings support our hypothesis that Colonial History did form an unintended nation brand via legal systems and attracted FDI.

Our findings fill a gap in the nation brand literature that largely focus on the intended brand. We present evidence that unintended nation brand can be powerful to attract investments. This could, hopeful, stimulate further research in the field of unintended nation brand. Moreover, this is a first study looking at the impact of legal families on FDI. Our findings show a fresh line of enquiry on FDI determinants that have been researched extensively for some time.

While scholars agree that the concept of 'similar economic behaviours' is linked to countries of the 'same legal-family groups', Klerman, Mahoney, Spanmann, and Weinstein (2011) argue that La Porta, Lopez-de-Silanes, Schliefer, and Vishny (1997, 1998); La Porta, Lopez-de-Silanes, and Shleifer's (2008) work on legal origins could not truly explain economic development. They claim that legal origins and colonial history are strongly correlated. It would be more appropriate to attribute the economic growth to other aspects of colonial policy. They re-classify the legal origin countries into five groups, namely, (1) former English colonies, (2) former French colonies, (3) former colonies of

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French civil law countries other than France (for example, Belgium, Italy, the Netherlands, Portugal, Spain, Ottoman Empire, and pre-communist Russia), (4) other former colonies and (5) countries never colonised. Their conceptual theory resides in the colonial history of the countries. This paper intends to follow the new legal systems classification based on colonial history to investigate further whether the trends of FDI activities could be better explained than the previous legal familiar classification.

As Kam (2011) shows that there are increasing proportions of global FDI from developed to developing economies. A logical question to ask is what are the factors that have motivated and influenced the recent trend of FDI movements? Specifically, we aim to provide answers to the following questions:

1. Does a country's legal family (unintended nation brand) matter for attracting FDI inflows to the developing countries?
2. Is applying the colonial powers theory proposed by Klerman et al. (2011) to classify legal families of countries providing a better explanation of the FDI movements than the previous classification?

The paper is organized as follows. The next section reviews the relevant literature and develops the theoretical framework of our study. Section 3 presents the classification of countries according to their legal family, colonial history, geographic and cultural factor. Section 4 presents the data and empirical methodology. Section 5 discusses findings and analyses the results. The final Section 6 concludes the paper.

## 2. Literature and theoretical framework

The effect of Nation Branding on FDI has been studied previously. For example, Kalamova and Konrad (2010) report that one index point increase on the Anholt Nation Brand Index can correspond to 27% increase of FDI, that is substantial. One important point emerging from the literature is that almost all of them focus on the 'designed' Nation Branding to attract FDI. In this paper, however, we are particularly interested in the effect of an *Unintended* Nation Brand in attracting FDI. Fan (2006) suggests that a nation can have a brand image without deliberating efforts of nation branding. This is an interesting and powerful insight. In a similar vein, Jaffie and Nebenzahl (2001) emphasise nation branding must embrace political, cultural, business and sport activities. These mean that a nation could have an unintended nation brand simply because of its historical political and culture rather than specially create one. Among all potential unintended nation brands, Klerman et al. (2011) ground breaking paper on Colonial History and Legal Origin prompt us to think that Legal systems could be a Nation Brand although it is not created by design. We are interested in the legal systems derived by the colonial history or in some countries no colonial history at all, and whether it can explain the trends of FDI observed.

### 2.1. Divergence of policies: during the Colonial era and the Post-colonial period

Engerman and Sokoloff (2002) argue that European colonisers adopted different institutional policies for their administration. They emphasise that the economic development of the colonial countries depends largely on which institutions – 'extractive' or 'protective' – the colonisers have established during the colonial era. During the colonial era, nearly all the colonisers established 'extractive' institutions in their ex-colonies from which they intended to exploit resources for their own interest. Such extractive institutional policies were commonly adopted elsewhere, with a few exceptions where protective institutions (favourable policies) were established in some selected colonies where the colonisers sought to settle down.

In the ex-colonies such as the countries in Latin America and the Caribbean, while the colonisers merely wanted to exercise their

'political powers' to exploit the benefits from their colonies, there is no incentive for them to educate the inhabitants as well as improving their basic infrastructure. Under the absolute political power of the colonists, most of the ex-colonies were unable to develop effectively because they did not provide a positive business environment (lack of skilled workers and modern infrastructure as well as deficiencies in legal enforcement) to attract foreign investment. Hence, these countries have had low development since the 19th century and thus fell behind economically.

In the Post-colonial period, most of the former colonisers have shown an interest in providing aid and assistance to their ex-colonies. They have endeavoured to help the ex-colonies to protect human rights and fight against inequality, and to promote democratization and economic development as well as condemning racism and apartheid.

It is reasonable to assume that, once a country able to provide a good educational human workforce; improved infrastructure and an effective legal system with enforcement to protect the investors' intellectual property rights, this country will be able to attract foreign investment. Investors basically intend to find a place where they can produce their goods at lower production cost (cheap labour and land) and can maximise their sales in larger markets as well as accessing an abundant supply of resources, provided that their property assets and investments can be protected. Thus, when the governments of the ex-colonies can proceed with their institutional reform to satisfy these elements of location advantages, which previously they did not have, their economies will gradually grow.

### 2.2. Classification of legal-families: English common law, French civil law

The characteristics of legal culture have been basically defined as "*ideas, values, expectations and attitudes towards law and legal institutions which some public or some part of public holds*" ((Freidman, 1977 in Nelken, 1977 (ed)). More explicitly, some authors refer to 'legal culture' as a part of the country's heritage synonymously with tradition (Ehrmann, 1976). Conclusively, Merryman (1985: 2) elaborates that a legal tradition is "*deeply rooted in historically conditioned attitudes about the nature of law... the role of law in ...operation of a legal system...It puts the legal system into cultural perspective*". Thus, a study of the legal system involves a number of legal traditions and sub-traditions providing an insight into the evolution of legal systems.

At the beginning of the 20th Century, researchers started conducting a wide range of comparative studies on the concept of 'families of law'. The study of comparative law was introduced aiming to underpin a unification of civilised legal systems. Glendon, Gordon, and Osakwe (1992) point out that legal scholars agree that some national legal systems are sufficiently similar in certain critical respects and, therefore, could be classified into major families of law. However, there was no unanimity way on the 'correct' classification of legal families.

In the recent decades, economists omit the former socialist legal system from their analysis base. Since then many writers (such as Glaeser & Shleifer, 2002 and La Porta et al., 2008) identify the countries as coming from two main traditions: Common law and Civil law in which they include French, German, and Scandinavian law as sub-traditions. As such, the laws of most countries are heavily influenced by either 'English common law' or 'French civil law'.

### 2.3. Legal origins theory

Over the last two decades, there has been a considerable body of research analysing the pervasive influence of a country's legal system in relation to legal rules and economic outcomes. La Porta et al. (1997, 1998) investigate the origins of each country's legal system, discussing its causal relationship with financial development and economic outcomes. They identify the countries as coming from two main traditions: English common law and French civil law in which La Porta et al. (1998) include German and Scandinavian law as sub-traditions. The legal system of common law countries originates from English law

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