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THE IMPACT OF SOCIAL NORMS ON FOREIGN DIRECT INVESTMENTS

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Abstract: This study examines the impact of social norms, measured through the Cultural Tightness-Looseness (CTL) index, on foreign direct investments (FDI) across 67 countries. I aimed to highlight a new approach from the sphere of cultural influences on bilateral FDI flows and to demonstrate the direct connection between the strictness imposed by a country's social norms and the investment decisions based on them. The results obtained were in line with the initial expectations, validating the level of constraint/permissiveness as a truly influential factor in relation to foreign direct investments.

JEL Classification: F21, G11, G15, Z10

Keywords: foreign direct investment, cultural tightness-looseness, economic growth.

1. Introduction

The global economy has always been full of mysteries waiting to be uncovered and challenges for which solutions had to be found. From the Great Economic Depression of 1929 to 1933 and up to contemporary crises, this essential element of social life has always been in a continuous dynamic. The speed at which events impacting the economy occur seems to be faster than ever, so all decisions must be made thoughtfully, analyzing all available information.

It is important to note that the prosperity of an economy largely depends on the investments made within it. Whether domestic or foreign, their impact is crucial when it comes to improving the quality of life for a country's citizens, a desire pursued since ancient times.

Considering all these aspects, I found it useful to study the influencing factors that determine the level of foreign direct investment (FDI) in a country. In this way, I first reviewed the existing literature and how various factors previously studied affect FDI flows, and then I venture towards a new possible direction of study, focusing on the relationship between social norms and the level of foreign direct

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investments between two countries. Whether we are talking about explicit norms, represented by laws and written regulations, or, on the contrary, implicit norms that include unwritten rules and customs, their essence is captured through the concept of Cultural Tightness – Looseness (CTL). This concept was first introduced by Michele Gelfand, the theory referring to the degree of constraint or permissiveness of social norms and rules in a culture or society and how they influence the behavior and mindset of people in that environment.

Specifically, in this study I aim to highlight how a country's CTL index manifests in relation to the foreign direct investments undertaken by it, as a result of the effect that the strictness or permissiveness of social norms in that country has on investment decisions.

Thus, the paper is structured as follows. In the first part, I presented some theoretical concepts, accompanied by a review of the specialized literature. Next, I described the data used as well as the methodology on which the study is based. Afterwards, I presented the results, and finally, I reviewed the conclusions reached and possible future directions of study.

2. Literature review

Foreign direct investment refers to the capital placements made by companies or even individuals outside their country of residence, aiming to exploit the business opportunities offered by the destination country. Over time, it has been demonstrated that one of the major advantages of these types of investments is their impact on a country's economic growth, which in turn leads to its economic development. Therefore, the importance of economic growth at the national level is undeniable, and foreign direct investments contribute significantly to it. The specialized literature in the field indicates a positive relationship between these two variables, with numerous empirical studies investigating the impact of foreign direct investment on economic growth, focusing on the various channels through which this influence manifests.

In 2006, Johnson hypothesized that foreign investments, in the form of technological improvements and physical capital contributions, significantly impact the evolution of an economy. To test this hypothesis, he used a panel of 90 countries and found that the impact is particularly observed in developing countries and less so in developed ones—a somewhat expected outcome given the growth potential in emerging economies. Thus, most recent empirical studies on these two variables highlight foreign direct investments as the most important channel for technology diffusion, which subsequently contributes to the development of an economy. Technology diffusion is considered the primary source of convergence between countries and the achievement of sustainable development (Elmawazini et al., 2008).

Recent literature seems to offer a careful evaluation of the host country's degree of acceptance of the dynamic relationship between foreign capital inflows and economic growth. Generally, FDI is viewed positively, given its contribution to job creation, increased labor productivity, the efficiency of resource allocation, the increase in the competitiveness of economies, and the reduction of regional disparities (Barrell and Pain, 1997; Kaminski and Smarzynska, 2001; Alfaro, 2003; Gorg and Greenaway, 2004; Moura and Forte, 2010). For instance, according to a study conducted by the European Commission in 2009, the accession of new states to the European Union was accompanied by an average economic growth of these economies of

approximately 1.75% during the 2000-2008 period. A decisive factor in this outcome, besides the improvement of the macroeconomic and institutional framework, was the increase in productivity driven by foreign direct investments and the technology transfer facilitated by these investments.

Starting from the fact that foreign direct investments represent a major component of the globalization process, having at the same time a stimulating role in a country's economy, it is of major interest to study the variables that determine the different levels of these investments from one state to another.

First, a major category of FDI determinants consists of rational factors, predominantly quantifiable factors related to the macroeconomic aspect, with the most mentioned in the specialized literature being Gross Domestic Product. GDP measures the added value generated by the production of goods and services within an economy over a specific period. A bidirectional relationship has been demonstrated between these two variables, where the evolution of one directly affects the other – on one hand, the larger a country's GDP, the more it will attract a significant number of foreign investors. On the other hand, a high level of FDI leads to accelerated economic growth (Kok & Ersoy, 2009). Similarly, Resmini (2000) found that in countries with greater development potential, higher FDI flows can also be noticed, as investors can fully exploit the available resources.

Furthermore, to better understand the reasons why the level of foreign direct investment differs from one nation to another, it is important to consider a number of behavioral factors that either favor or inhibit an investor's decision to make a cross-border capital placement.

One initial approach, based on the level of religiosity exhibited by a nation's citizens, was studied by Miller (2003), who highlighted the connection between religion and an individual's anxiety level, suggesting that risk-averse individuals are often characterized by a strong belief system to alleviate their anxieties and avoid uncertainty in their lives. Recently, several studies have empirically documented the correlation between religiosity and risk aversion (Hilary & Hui, 2009; Liu, 2010; Dohmen et al., 2011), explaining the hesitant attitude of individuals from highly religious countries when it comes to making investment decisions in foreign countries. Subsequently, Hong et al., in an article published in 2023, strengthened the existing research on religious diversity and its influence on foreign direct investment. They showed that religious differences inhibit FDI flows between two countries, using religious distances calculated directly as the difference between two demographic religious distributions. Moreover, the previously mentioned study highlighted that the negative effect of religious differences on FDI flows is mitigated in host countries with greater religious diversity, as in such contexts, the ideas and personal values of each individual are accepted by others.

In another context, it is also of interest to focus on other factors related to human behavior, whose influence cannot be neglected when it comes to foreign direct investments.

Literature has established individual values, in the form of principles and beliefs that guide a person's behavior and decision-making process, as being closely linked to FDI flows. One approach derived from individual values and correlated with the investment domain is investor trust, which springs from their sentiment towards a particular action and is cultivated over time through experiences and interactions with other market actors. In this regard, existing empirical research brings to the

forefront the direct connection between individual trust and the abundance of foreign direct investments. More precisely, a study conducted by Guiso, Sapienza, and Zingales in 2009 showed that a significant level of trust that dominates bilateral relations between two states favors foreign investments.

Additionally, we must also consider the impact of cultural values - specifically the six cultural dimensions defined by Dutch researcher Geert Hofstede - have on the level of foreign direct investments. This model has become a paradigm for comparing national cultures, as it delimits cultural characteristics into the following categories: Power Distance, Uncertainty Avoidance, Individualism/Collectivism, Masculinity/Femininity, Long-Term/Short-Term Orientation, and Indulgence/Strictness. All these have been the subject of numerous studies, which have ultimately demonstrated the existing connections between cultural dimensions and foreign direct investments (Tang, 2012; Husted & Allen, 2006).

3. Predictions

Building on the ideas developed in the studies I previously analyzed, I aim to improve the state of knowledge in the field of foreign direct investments and the factors that influence it. The novelty I intend to introduce into the specialized literature focuses on investigating how social norms affect the flow of foreign direct investments. Based on Gelfand's findings (2011), which measure the level of cultural tightness or looseness within a society, we know that stricter nations, which impose clear rules expected to be followed by citizens, tend to develop a high degree of aversion to risk-taking and deviation from traditional societal norms. Additionally, countries that fall into this category tend to be more conservative, rarely accepting to engage in any form of relationship with other states that are guided by different principles compared to those accepted in the domestic space. Considering the collective behavioral traits that accompany this high degree of strictness imposed by social norms in a country – a behavior that is also reflected in the economic decision-making process – I strictly focus on how such a society relates to the opportunities for establishing investment relationships with another state through foreign direct investments directed towards the targeted destination. More precisely, I intend to test whether the bilateral FDI flow is indeed affected by the strict social norms of the country of origin, based on the following research hypothesis: *Societies that are more restrictive in terms of social norms will make fewer investments outside their borders.*

4. Data

The analysis is based on data collected from a sample of 67 countries, representing both developed and emerging economies. The representativeness of the sample is guaranteed by the fact that there are significant flows of foreign direct investments between these states, as evidenced by the databases provided by the International Monetary Fund (IMF). The volume of FDI flows is reported annually for pairs of countries, starting from 2009, an aspect I considered when selecting the analysis period, this study being based on the available data from 2009 to 2021.

Furthermore, for the countries included in the sample, I collected the Cultural Tightness-Looseness index values for each of them and then I added to the database values of other variables that also play an important role in determining the size of investment flows between two countries.

I mention from the beginning that in order to facilitate the effective comparison of each investment flow recorded between two countries over the course of a year, I worked with the logarithmic values of foreign direct investments, the dependent variable becoming as follows:

$$Invest_{ij,t} = ln\ (1 + the\ abs.value\ of\ the\ invest._{ij,t})$$

there $the\ abs.value\ of\ the\ invest._{ij,t}$ represents the absolute value of foreign direct investments between two countries in year t.

When it comes to the CTL index, I used one of the measures developed by Uz in 2015, *The Combination Index*, which consists of a sequence of approaches. It begins with a targeted analysis of individual domains, followed by a broader analysis encompassing a wider range of domains, all with the aim of extracting the degree of constraint/permissiveness within a nation.

In my analysis, in addition to the exogenous variable represented by the CTL index, I also used a series of control variables to quantify the effect of various factors on the level of foreign direct investments recorded between the countries in the sample. Therefore, considering the empirical evidence from the studies mentioned in the theoretical section, I included the most relevant control variables in the built models: GDP, GDP per capita, trade openness, geographical distance, contiguity between states, religious distance, legal system, and the World Governance Index.

To build the regressions that would help validate the initially formulated hypothesis, I compiled a database by collecting, for each country included in our sample, the corresponding values of the variables that were determined to have or potentially have an influence on our endogenous variable – foreign direct investments logarithms. Table 1 thus illustrates the descriptive statistics of the variables used in the attempt to estimate optimal econometric models that reflect the relationship between the CTL index and FDI flows.

Between 2009 and 2022, the largest bilateral FDI flow recorded within the sample was between France and the United Kingdom, occurring in the first year of the reference period, with an absolute value exceeding $55 billion. Regarding the CTL index, it has an average value of 60.009 among the countries included in the sample, with Morocco being the most restrictive country, having an index value of 0, while the most permissive country is Belgium, with a maximum value of 119.8.

Table 1. Descriptive statistics

Variable	Obs.	μ	σ	Min	Max
Dependent variable ln(1+FDI)	53494	2.225	5.851	0.000	24.743
Independent variables CTL_C (home country)	29642	60.009	26.830	0.000	119.8
CTL_C (host country)	29642	60.009	26.830	0.000	119.8
ln(GDP home country)	53494	26.454	1.691	19.559	30.780
ln(GDP host country)	53494	26.454	1.691	19.559	30.780
ln(GDP/cap home country)	53494	9.462	1.230	6.624	11.547
ln(GDP/cap host country)	53494	9.462	1.230	6.624	11.547
Home trade openess	53494	0.009	0.037	0.000	1.946
ln(geographic distance)	53494	8.597	0.910	4.493	9.892
Common border	53494	0.051	0.220	0.000	1.000
Linguistic distance	52662	0.865	0.306	0.000	1.000
Religious distance	52662	0.720	0.293	0.000	0.998
Same legal system	53494	0.631	0.483	0.000	1.000
WGI	53494	62.435	23.385	3.332	96.748
Financial literacy	51492	42.848	14.783	21	71
Power Distance	53494	57.457	23.544	0.000	100.000
Individualism/Collectivism	53494	46.363	25.909	0.000	100.000
Masculinity/Femininity	53494	46.528	21.287	0.000	95.000
Uncertainty Avoidance	53494	63.285	25.597	0.000	100.000
Long-Term Orientation	53494	43.311	23.447	0.000	100.000
Indulgence/Strictness	53494	42.451	26.542	0.000	100.000

Source: Author's own research, using Stata.

5. Methodology

To empirically test the proposed study hypothesis, I estimated linear regressions using the Ordinary Least Squares (OLS) method, based on panel data collected for each country included in the sample. Ultimately, I was able to capture the relationships between the variables through the following regressions:

The benchmark regression, which exclusively captures the influence of the control variables on the level of foreign direct investments between two countries, providing a reference point against which to observe the changes that occur when additional variables are added to the model:

$$Invest_{ij,t} = a_0 + Control\ var. + \varepsilon_{i,t}$$

I then investigated the relationship between the CTL index of the home country and FDI flows, starting from the regression below:

$$Invest_{ij,t} = a_0 + a_1 x\ CTL\_C_i + Control\ var. + \varepsilon_{i,t}$$

where CTL_C_i is the CTL index of the country of origin; lower values indicate stricter social norms, while higher values illustrate a greater degree of permissiveness of social norms.
Similarly, I analyzed the relationship between the CTL index of the destination country and FDI flows, according to the model:

$$Invest_{ij,t} = a_0 + a_2 x\ CTL\_C_j + Control\ var. + \varepsilon_{i,t}$$

where CTL_C_j is the CTL index of the destination country.
Next, I built an econometric model that captures the impact of social norms in both countries involved in investment relationships:

$$Invest_{ij,t} = a_0 + a_1 x\ CTL\_C_i + a_2 x\ CTL\_C_j + Control\ var. + \varepsilon_{i,t}$$

Last but not least, I built a regression using the CTL index of the country of origin, exclusive of the effects of Hofstede's six cultural dimensions:

$$Invest_{ij,t} = a_0 + a_3 x\ CTL\_C\_rez_i + Control\ var. + \varepsilon_{i,t}$$

where $CTL\_C\_rez_i$ is the CTL index of the country of origin adjusted for the effects of the cultural dimensions.

6. Results

Throughout numerous attempts to construct the most representative regressions, I juggled the variables in such a way as to find the optimal combination that best reflects the impact of social norms on foreign direct investments and thus I developed the models summarized in Table 2.

First, I state that all regressions were built using time effects to capture the common variance across all units within a given year, thereby aiming to eliminate potential bias caused by time-varying factors that are not directly measured.

The benchmark regression in the first column of the table captures the impact of all variables besides the social norms on foreign direct investments, providing a reference point for observing changes once additional variables are added to the model. Among the essential variables included in the benchmark regression are the natural logarithm of GDP for both the country of origin and the destination country. We observe that the GDP of the destination country is the primary factor influencing

the absolute volume of investments, with a direct relationship reflected by a coefficient of 0.518, which is significant with a 99% probability. The standard error is only 0.045, leading us to believe that indeed, the larger the GDP of the destination country, the more attractive it is to investors, and as a result it will attract more FDI flows. Additionally, in the benchmark regression, we note that factors with an indirect influence on FDI include geographical distance and religious distance. Both of them are significant at a 1% confidence level, but the latter has a stronger impact with a coefficient of -1.632.

The following three estimated regressions include, in turn, the CTL index of the country of origin, the CTL index of the host country, and the simultaneous action of both. From the results obtained, it appears that only the CTL index of the country of origin influences the decision to make a foreign direct investment, as evidenced by the coefficient value of 0.044 in regression (2) and 0.048 in regression (4); in both cases, these coefficients are significant at a 1% confidence level. The same cannot be said for the CTL index of the destination country, which does not appear to have a significant impact on the explained variable, with its coefficients being almost null in both cases. In this context, the influence of control variables remains similar to that observed in the case of the benchmark regression, the GDP still being a major factor of influence. Additionally, the similarity between the legal systems of the two countries establishing investment relationships is also notable, especially in regression (4), where it has a coefficient of 1.206, indicating that legal system identity positively influences the foreign direct investments.

Table 2. The impact of CTL on FDI

Variable	ln(1+FDI)						
	(1)	(2)	(3)	(4)	(5) (%)	(6)	(7) (%)
CTL_C (home country)		0.044*** (0.004)		0.048*** (0.006)	19.00		
CTL_C (host country)			0.003 (0.004)	0.008 (0.006)	3.50		
CTL_C_rez (home country)						0.048*** (0.005)	13.03
ln(GDP home country)	0.233*** (0.042)	0.522*** (0.077)	0.217*** (0.057)	0.555*** (0.106)	11.88	0.484*** (0.074)	10.69
ln(GDP host country)	0.518*** (0.045)	0.807*** (0.071)	0.556*** (0.065)	0.883*** (0.101)	19.35	0.845*** (0.071)	21.85
ln(GDP/cap home country)	0.289*** (0.061)	0.197** (0.097)	0.287*** (0.085)	0.211 (0.134)	3.81	0.802*** (0.087)	15.04
ln(GDP/cap host country)	0.043 (0.058)	-0.009 (0.090)	-0.103 (0.095)	-0.262* (0.151)	-4.72	-0.062 (0.091)	-1.16
Home trade openess	6.569*** (1.868)	-1.585 (5.423)	8.194 (5.071)	5.608 (5.331)	2.25	-3.871 (5.507)	-1.61
ln(geographic distance)	-1.465*** (0.098)	-1.946*** (0.140)	-1.627*** (0.132)	-2.209*** (0.193)	-30.61	-2.059*** (0.140)	-29.10

Common border	0.108 (0.497)	-0.239 (0.647)	-0.065 (0.648)	-0.794 (0.827)	-2.88	-0.345 (0.646)	-1.20
Religious distance	-1.632*** (0.260)	-2.608*** (0.409)	-1.473*** (0.345)	-2.056*** (0.559)	-8.45	-3.010*** (0.413)	-12.88
Same legal system	0.562*** (0.128)	0.921*** (0.206)	0.650*** (0.179)	1.206*** (0.297)	8.23	1.053*** (0.210)	7.61
WGI	0.041*** (0.003)	0.011** (0.004)	0.045*** (0.004)	0.011* (0.006)	4.22	0.010** (0.004)	3.92
Control variables	YES	YES	YES	YES	YES	YES	YES
Time effects	YES	YES	YES	YES	YES	YES	YES
F_stat	45.73	46.47	28.54	33.08	254.06	45.17	426.13
R^2	0.193	0.256	0.211	0.281	0.281	0.254	0.254
Observations	52662	28810	29187	15607	15607	28810	28810

Symbols ***, **, * indicate statistical significance at the 1%, 5% and 10% levels, respectively.

Starting from the model with the CTL indices of both countries as exogenous variables, I estimated a beta regression, revealing that social norms in the country of origin influence FDI flows by 19%, while the norms of the host country affect the exogenous variable by only 3.5%. These weights further confirm that, when making an investment decision, the cultural characteristics of the country of origin tend to be more significant, which means that the frequency and size of investments directed towards foreign economies will be dictated by the rigor of the cultural norms in the origin country.

To ensure that the significant exogenous variable is exclusively the CTL index measuring the strictness of social norms in the country of origin, I estimated an additional regression, shown in column (6) of the table, illustrating the influence of a new variable, suggestively named CTL_C_rez, while keeping the control variables unchanged. This new measure was obtained by removing the effects of other cultural factors derived from Hofstede's cultural distances from the CTL index values. Analyzing the results, it can be observed that the coefficient of the newly introduced variable remains 0.048, being significant at a 1% confidence level. The identity between it and the coefficient of the CTL index of the country of origin from regression (4) is not accidental, as it reinforces the idea that the country of origin is the main pillar determining foreign investments, especially since, in regression (6), the standard error is even smaller, at only 0.005.

The last regression in Table 2 is also a beta regression built based on the previous model, and it helps identify the two main factors directly influencing FDI flows: the CTL index of the origin country, with the effects of cultural dimensions excluded and the GDP of the destination country. Additionally, geographic distance also has a considerable impact, however, in the opposite direction this time. This variable must be carefully considered when estimating regressions aimed to determine the factors influencing foreign direct investments.

Robustness tests

To ensure that the previous estimations are accurate, I applied a series of robustness tests to the initially built regressions, thereby observing any significant changes in the coefficients corresponding to the variables, as well as their significance and estimation errors.

By comparing the results from the new regressions in Table 3 with those obtained from the classical estimation, it can be observed that they are similar, which is very favorable. One notable difference to address, however, concerns the values of the CTL index coefficients for the host country, which have decreased to zero. This further emphasizes that social norms in the country in which the investment is made do not have a direct influence on the investment decision, especially when other variables of greater importance are also included in the equation. On the other hand, generally speaking, some parameters either decrease in value or lose their significance, but this does not necessarily affect the overall interpretation of the regressions.

Table 3. Estimation of Tobit models

Variable	ln(1+FDI)			
	(1)	(2)	(3)	(4)
CTL_C (home country)	0.009***		0.009***	
	(0.001)		(0.001)	
CTL_C (host country)		-0.000	0.000	
		(0.001)	(0.001)	
CTL_C_rez (home country)				0.007***
				(0.001)
Control variables	YES	YES	YES	YES
Time effects	YES	YES	YES	YES
Observations	28810	29187	15607	28810

Symbols ***, **, * indicate statistical significance at the 1%, 5% and 10% levels, respectively.

Furthermore, Table 3 shows that the standard errors have significantly decreased for all obtained coefficients. This is a positive development that further reinforces the validity of the models. Overall, testing the regressions with the new Tobit models confirms that there is an important and non-negligible relationship between the social norms of the origin country and the investment flows that emerge over time.

Moving forward, I will also consider a new model available for estimating regressions and which aids in testing the initially obtained results: the Probit model. Table 4 briefly illustrates the parameters estimated using this model, which largely follow the same pattern as those mentioned in the case of the Tobit models.

However, it should be noted that in the regressions illustrating the impact of social norms on foreign direct investments, I transformed the initial endogenous variable, which quantified the volume of FDI flows between pairs of countries over the reference years, into a dummy variable that expresses only the presence or absence of these investments. Specifically, if foreign investments were recorded, the variable was assigned a value of 1; otherwise, it was assigned a value of 0.

In the Probit models as well, the coefficients generally decreased, however they remained significant, which is particularly important for the main exogenous variable—the CTL index specific to the origin country. Additionally, the absence of a relationship between social norms in the host country and the recorded foreign investment flows at that level can also be observed, suggesting that not all factors included in the model do necessarily have an influence on the endogenous variable.

Table 4. Estimation of Probit models

Variable	Investment decision (yes/no)			
	(1)	(2)	(3)	(4)
CTL_C (home country)	0.010*** (0.001)		0.010*** (0.001)	
CTL_C (host country)		-0.000 (0.001)	0.000 (0.001)	
CTL_C_rez (home country)				0.008*** (0.001)
Control variables	YES	YES	YES	YES
Time effects	YES	YES	YES	YES
Observations	28810	29187	15607	28810

Symbols ***, **, * indicate statistical significance at the 1%, 5% and 10% levels, respectively.

7. Conclusions

The empirical study led to optimal results on the basis of which a series of arguments can be formulated that ultimately support the initial hypothesis.

Specifically, I was able to demonstrate that in terms of social norms, only those at the level of the foreign direct investment origin country have a significant impact on an individual's decision to make capital placements beyond the borders of their home country. This is a direct influence, meaning that as the CTL index of the origin country decreases – indicating stricter norms imposed on citizens – investments are likely to be nearly nonexistent or at an extremely low level. To better

understand this causal relationship, it is important to note that in such countries, any deviation from the norms imposed by the central authority is harshly punished. As a result, an investor will be hesitant to invest in a foreign country due to the fear of deviating from the strict rules of his home country. On the other hand, permissive societies, as reflected by a high CTL index, will see a significant volume of FDI flows. This is because such societies encourage and support individuals to explore the unknown and be open to the novelties and changes characteristic of the dynamic modern world. These individuals are less likely to hesitate to venture beyond their borders and seek profits from investing in economies where development potential is high or production factors (capital and labor) are cheap, even if this involves taking considerable risks.

In conclusion, the final thoughts can be summarized in a few lines that emphasize potential future research directions equally. Thus, I consider this paper to be useful when it comes to understanding the impact of social norms on foreign direct investments. The dynamics of the contemporary economy make the volume of FDI increase significantly day by day, however, for an investment to truly generate benefits for both parties involved, it must always be preceded by a review of the relevant literature.This study is both revealing and paves the way for new, unexplored research directions that await exploration in the coming years.

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