Ethnocentrism Reduces Foreign Direct Investment

Sarah Andrews  
sca4ws@virginia.edu

Sonal Pandya  
spandya@virginia.edu

David Leblang  
leblang@virginia.edu

Department of Politics  
University of Virginia

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Abstract

The tension between global economic integration and ethnocentrism is a growing political force across industrialized countries. Whereas extent research focuses on ethnocentrism’s influence on individual attitudes, we show that ethnocentrism directly exacerbates economic decline by reducing greenfield foreign direct investment (FDI), the creation of new foreign-owned firms. We exploit greenfield FDI’s universal popularity to isolate ethnocentrism’s effects on economic activity. Our analysis of US state greenfield FDI flows during 2004-2011 also holds constant country-level factors that correlate with both ethnocentrism and propensity to receive FDI. A one standard deviation increase in state-level ethnocentrism corresponds to nearly $100 million less greenfield FDI and 50 fewer jobs per state-year on average. Findings are robust to controls for state economic conditions, FDI transactions costs, existing FDI stock, size of foreign-born population, and state partisanship. These findings demonstrate the economic cost of ethnocentrism-based political strategies and that mass political sentiment undermines economic integration.
Brexit, the election of Donald Trump, and the ascendance of far right political movements lay bare a sharp and rising tension between global economic integration and ethnocentrism, the psychological tendency to parse the world into virtuous in-groups and nefarious out-groups. Public opinion research correlates ethnocentrism with opposition to immigration, trade, and foreign outsourcing. These findings suggest that ethnocentrism’s effects are indirect, manifesting in mass political behavior that in turn may shape policy (Kinder and Kam 2009).

By contrast, we argue that ethnocentrism directly undermines economic integration. Ethnocentrism erodes the trust necessary to form and sustain cross-border contractual relationships, creates an aversion to the consumption of foreign products, and weakens the information exchange necessary for efficient markets (Verleigh and Steenkamp 2009, Guiso et al 2009, Fernández 2011). The challenge to establishing ethnocentrism’s direct costs is that it correlates with other country characteristics that influence the depth of economic integration. A further challenge is parsing ethnocentrism from concerns about integration’s economic effects.

We demonstrate ethnocentrism’s direct costs by exploiting the popularity of greenfield foreign direct investment (FDI), foreign firms’ investments to establish new production facilities. Even the most ethnocentric politicians and voters covet greenfield FDI as a source of new jobs and economic activity. In a recent Pew survey, 75 percent of US respondents favored greenfield FDI whereas only 28 percent supported foreign acquisitions of US firms (Pew Research Center 2014, 14.) Greenfield FDI is the entry of new firms so it does not cost jobs, add fiscal burdens, or present other standard economic reasons for opposing global integration. US voters reward state

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1 For example, Mansfield and Mutz 2009, 2013; Hainmueller and Hiscox 2010.
politicians who court greenfield FDI, even when those efforts are unsuccessful (Jensen et al 2014, 2015). The US imposes minimal policy barriers to greenfield FDI. Greenfield investors are also more flexible in their subnational location decisions then investors acquiring existing firms, and thus have greater latitude to consider local conditions like political sentiments. From the investors’ perspective, anti-foreigner attitudes undermine productivity. Specific channels include increased turnover of foreign managers and potential bias in local supplier relationships.\(^3\)

Our analysis of annual US state inflows of greenfield FDI during 2004-2011 shows that states with stronger ethnocentrism receive less FDI. A one standard deviation increase in ethnocentrism corresponds to nearly $100 million less greenfield FDI into a state-year on average. Based on our back of the envelope calculation, the one standard deviation increase in ethnocentrism translates into 50 fewer jobs per state-year on average. In analyzing greenfield FDI flows across US states, we hold constant country-level drivers of FDI, including those that correlate with ethnocentrism. Subnational location decisions do not reflect broad cultural and institutional differences between countries because we observe firms that have already decided to invest in the US. Ethnocentrism, measured as anti-immigration sentiment, fluctuates across states and over time. Our findings are robust to controls for state economic characteristics that independently influence ethnocentrism and attractiveness to foreign investors. Additional robustness tests consider transactions costs, existing FDI, the size of the foreign-born population, alternate measures of ethnocentrism, and state politics.

Our findings indicate that ethnocentrism creates tangible economic costs, and that its effects are above and beyond any indirect effects via policy outcomes. To the extent that

\(^2\) Most US FDI regulation pertains to the foreign acquisition of US-owned firms.

\(^3\) See online appendix for detailed discussion of theoretical mechanisms.
ethnocentrism hinders cross-border economic exchange, it is a binding constraint on formal economic integration. This insight can help explain the underperformance of international economic agreements in producing deeper economic integration (Mansfield and Milner 2012).

Additionally, we demonstrate that FDI flows are sensitive to mass political sentiments. Although political institutions occupy a central role in FDI research, the role of mass political sentiment in driving FDI has been overlooked. We show that holding institutions constant, ethnocentrism shapes foreign firms’ location decisions, even when public support for investment itself is very high. Ethnocentrism represents a new and growing source of political risk, especially in advanced economies that have traditionally embraced FDI.

**Empirical Analysis**

We model US state-year greenfield FDI during 2004-2011. Depending on the year, firms from 80-120 countries invest in at least one US state. These data are from the *Financial Times’ fdiIntelligence* database, the leading sources for greenfield FDI data. Annual state greenfield FDI inflows is the sum of newly announced capital investment by firms headquartered outside of the US. *Greenfield* is the inflation-adjusted log dollar value of all greenfield FDI into US state $j$ in year $t$. Our data has many zeros, reflecting state-years with no investment. We estimate tobit

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4 See Pandya 2016 for a review.


6 Data availability dictated the sample period.

7 Logs attenuate outliers. We add one to all observations to preserve zero value observations.
models, which are appropriate for censored dependent variables. All models include state fixed effects and robust standard errors clustered by state.

We measure ethnocentrism using state-year sentiment towards immigrants. We utilize the universe of national Gallup polls conducted during the sample period that include at least one question on immigration attitudes. At least four times per year polls included the question “Do you favor increasing the [country’s] level of immigration?” or “Do you favor liberalizing [US] immigration policy?” We construct Ethnocentrism by standardizing survey responses such that “1” reflects pro-immigration sentiment and “0” reflects anti-immigration sentiment, and calculating average sentiment for each state-year. We expect that higher anti-immigrant sentiment corresponds to less greenfield FDI.

We control for several state characteristics that influence foreign firms’ location decisions. Agglomeration – the geographic clustering of FDI – facilitates knowledge spillovers (Head et al 1995, 1999; Bobonis and Shatz 2007). We expect agglomeration to boost FDI irrespective of ethnocentrism. We include $log(Greenfield Investment)_{t-1}$, the sum of all greenfield FDI into state j in the previous year and $log(Number of Foreign Acquisitions)$, the total number

8 We also estimate OLS models and obtain consistent results (see online appendix).

9 Findings are also robust to inclusion of year fixed effect (see online appendix).

10 We have 6-16 polls/year. Years closer to a presidential election year have more annual polls.

11 Some surveys give the option to maintain the status quo. We assign .5 to these cases. We used local polynomial smoothing to remove noise from state-years; this significantly affected only three states with relatively few respondents: Alaska, Wyoming, and Idaho. We verify our findings are robust to an analogous measure of pro-immigration. See online appendix.

12 See online appendix for data sources and all summary statistics.
of foreign takeovers of US firms.\(^{13}\) Both variables also control for unobserved and time-varying aspects of states’ attractiveness to foreign firms.

A variety of state economic traits are salient to foreign firms’ location decisions.\(^{14}\) We control for general economic characteristics with the annual log of per capita gross state product (GSP). Dependence on natural resources, Minerals/GSP, controls for a state’s propensity to receive natural resource sector FDI. This sector lacks location flexibility so foreign investors have less scope to consider anti-immigrant sentiment. Lower transactions costs, measured by the number of free trade zones in the state and the volume of international air passenger traffic in each state’s airports, should correspond to greater investment.

State labor market characteristics drive firms’ calculations of production costs.\(^{15}\) We control for states’ annual unemployment rate and the average hourly wage.\(^{16}\) Inclusion of the state poverty rate accounts for economic drivers of ethnocentrism. We also control for the share of college graduates as a percent of state population because firms locate in states with high human capital and more highly educated populations exhibit less ethnocentrism (Hainmueller\(^{16}\)).

\(^{13}\) Greenfield FDI and foreign acquisitions are rarely substitutes. The former is a strategy to enter markets or expand vertical supply chains whereas the latter is to acquire productive assets (Nocke and Yeaple 2007).

\(^{14}\) Data on states’ investment incentives are unavailable but incentives rarely drive firms’ location decisions (Head et al 1999, Jensen et al 2014, 2015). Indeed, research on incentives focuses on why they are political popular despite being ineffective.

\(^{15}\) State labor laws do not vary during the sample period.

\(^{16}\) We are agnostic as to the sign of these coefficients. Firms want minimize costs but higher wages typically correspond to greater productivity.
and Hopkins 2014). Additionally, we control for the share of a state’s population that is foreign born as the existing concentration of immigrants within a state could drive immigrant sentiment. This variable also controls for unobserved, time-varying state characteristics that influence a state’s appeal to foreigners.

Table 1 summarizes our findings. In the baseline model (Model 1) ethnocentrism has a negative and statistically significant coefficient. Substantively, a one unit increase in ethnocentrism translates into $2 million in forgone state-year greenfield FDI on average. A one standard deviation rise in ethnocentrism corresponds to nearly $100 million in lost state-year greenfield FDI on average. Using fdiIntelligence data on the number of state jobs created via greenfield FDI, we estimate $2 million of greenfield FDI produces one job on average in a state-year.17 Thus a one standard deviation increase in ethnocentrism translates into fifty lost jobs per state-year on average.

Ethnocentrism’s effect is robust to the inclusion of a variety of state-level characteristics discussed above that could determine FDI flows or sentiment towards immigrants. Model 1 also demonstrates agglomeration effects as both \( \log(\text{Greenfield Investment}) \) and \( \log(\text{Number of Foreign Acquisitions}) \) are positive and significant.

We estimate an expanded model (Table 1, Model 2) to further flesh out these results. State immigration laws can also be a strong signal of ethnocentrism. States’ legal authority on immigration is limited to undocumented migrants so state immigration laws do not otherwise affect foreign firms. We operationalize laws as the number of anti-immigrant laws passed in the preceding legislative session. We classify anti-immigration laws that restrict undocumented

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17 We regress the number of jobs created on the amount of greenfield FDI and include state fixed effects and obtain a parameter estimate of .40 for greenfield FDI.
migrants access to public services and/or benefits including documentation requirements for
driver’s licenses and employment eligibility. Inclusion of this variable does not change our core
finding. Related, the partisan composition of state government points to likelihood of elite cuing
of ethnocentrism. We include measures of the share of state house and senate seats held by the
Democratic Party. We find that the percent of state house seats held by Democrats correlates
with more greenfield FDI but ethnocentrism continues to have a strong and negative effect on
greenfield FDI into US states.

**Conclusion**

While analyses of opinion surveys explain individual-level sentiments towards the global
economy, we show that ethnocentrism directly undermines economic integration. By linking
anti-immigrant sentiment to reduced flows of greenfield FDI, an exceptionally popular form of
global economic integration, we show that ethnocentrism deters foreign investors. Thus, national
identity does more than shape policy preferences about economic integration, it directly
influences the depth of markets. Political economy researchers should further explore the direct
effects of national identity on economic integration through analysis of behavioral outcomes
linked to national identity including their decisions to purchase imported goods, allocate
financial portfolios, and visit foreign countries.

Of topical relevance, our findings establish the economic costs of electoral strategies that
stoke anti-immigrant sentiment. Across industrialized countries politicians are gaining influence
and power with anti-immigrant platforms that link migrants to a wide range of social and
economic ills. Politicians who vilify migrants may exacerbate poor economic conditions by
deterring foreign investors who create new jobs and boost overall economic performance.
References


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<thead>
<tr>
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<th>(1)</th>
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<tbody>
<tr>
<td>Ethnocentrism</td>
<td>-2.017***</td>
<td>-1.836**</td>
</tr>
<tr>
<td></td>
<td>(0.718)</td>
<td>(0.727)</td>
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<tr>
<td>Log(Greenfield Investment)_{t-1}</td>
<td>-0.163**</td>
<td>-0.142*</td>
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<tr>
<td></td>
<td>(0.0792)</td>
<td>(0.0840)</td>
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<tr>
<td>Log(Number of Foreign Acquisitions)</td>
<td>0.00914*</td>
<td>0.00455</td>
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<tr>
<td></td>
<td>(0.00532)</td>
<td>(0.00430)</td>
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<td>Log(Gross State Product Per Capita)</td>
<td>3.830</td>
<td>2.743</td>
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<td></td>
<td>(2.664)</td>
<td>(2.556)</td>
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<td>Share State Pop w/ College</td>
<td>-3.942</td>
<td>8.780</td>
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<td></td>
<td>(21.83)</td>
<td>(22.23)</td>
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<td>Unemployment Rate</td>
<td>-0.0379</td>
<td>-0.0830</td>
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<td>(0.0760)</td>
<td>(0.0723)</td>
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<td>Number Free Trade Zones</td>
<td>0.0918</td>
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<td></td>
<td>(0.226)</td>
<td>(0.232)</td>
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<td>Minerals/GSP</td>
<td>13.24</td>
<td>12.80</td>
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<td></td>
<td>(13.80)</td>
<td>(13.44)</td>
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<tr>
<td>Average Hourly Wage</td>
<td>5.872**</td>
<td>4.440*</td>
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<td>(2.373)</td>
<td>(2.307)</td>
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<td>Poverty Rate</td>
<td>-0.0399</td>
<td>0.0111</td>
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<td></td>
<td>(0.0639)</td>
<td>(0.0583)</td>
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<td>Share Pop. Foreign Born</td>
<td>-24.38</td>
<td>-18.70</td>
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<td></td>
<td>(43.75)</td>
<td>(43.66)</td>
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<td>Number Foreign Air Passengers</td>
<td>-0.0500</td>
<td>0.213</td>
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<td></td>
<td>(1.213)</td>
<td>(1.265)</td>
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<tr>
<td># Anti-Immigrant Bills Enacted</td>
<td>0.175</td>
<td>(0.149)</td>
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<tr>
<td>Percent Democratic State House Seats</td>
<td>6.065**</td>
<td>(2.428)</td>
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<tr>
<td>Percent Democratic State Senate Seats</td>
<td>-0.421</td>
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</table>

Observations | 381 | 374 |

Cell entries are tobit coefficients estimated via maximum likelihood with robust standard errors clustered by state. The dependent variable is log(greenfield investment) into state i at time t. State fixed effects are included but their coefficients are not reported.

***p<0.01, **p<0.05, *p<0.10