Chapter 79
Does Trust Matter for Foreign Direct Investment Decisions?

Sibel Bali Eryigit
Uludag University, Turkey

ABSTRACT

Factors affecting the investment decisions of multinational companies are heavily researched in the literature. However, the number of studies dealing with the socio-cultural characteristics of host countries among these factors is quite limited. Among the cultural characteristics affecting location decisions, one of the primary cultural characteristics is the general level of trust between individuals. In this scope, this chapter intends to research whether the general level of trust in a society has an effect on the location decisions of foreign investors. In line with this objective, an analysis will be conducted by employing the panel data method for 39 emerging market countries for the period between 1998 and 2011. According to the results of the study, a low general level of trust in the host country represents a significant disadvantage for the attraction of foreign direct investments.

1. INTRODUCTION

The impact of foreign direct investments (FDIs) on economic development is intensively researched in the literature. The relevant literature has proven many times that FDI promotes economic growth in the host country by providing the transfer of new knowledge and technologies, creating employment opportunities and increasing capital accumulation. Thus, FDIs are particularly important for emerging markets, as they do not have sufficient capital accumulation for industrialization. Due to the importance of FDIs, the literature has heavily researched the factors affecting FDI decisions. The studies underline that there are many factors that influence multinational firms' decisions about FDIs, such as the host country's market size the distance to other markets, openness, and incentives given to foreign investors, macroeconomic stability, tax advantages, human capital, and infrastructure quality. However, there are quite a few studies on the impacts of the socio-cultural dynamics of host countries on FDI decisions in the relevant literature.

DOI: 10.4018/978-1-7998-2448-0.ch079

Among the socio-cultural characteristics of host countries that affect location decisions, one of the primary cultural characteristics is the general level of trust between individuals. So, the primary objective of this study is to assess the impact of the general level of trust in the host country on the FDI decisions in that country. As there are quite few studies conducted in this sphere, it is thought that this study will contribute significantly to the literature. In line with this objective, an analysis will be conducted by employing the panel data method for 39 emerging market countries for the period between 1998 and 2011.

The plan of this study is as follows: The introduction section will present the subject and aim of the study, as well as its contributions to the literature. The theoretical background and related literature section will deal with the place and importance of trust in economics, and it will also address the impact of the level of trust on investment relations by discussing the impact mechanisms. The third section will deal with the empirical methodology employed in the study. The fourth section presents the model and data. The fifth section will present the empirical findings. Lastly, the empirical results obtained under the title conclusions are discussed.

2. THEORETICAL BACKGROUND AND RELATED LITERATURE

According to Fukuyama (1995), a nation's well-being, as well as its ability to compete, is conditioned by a single pervasive cultural characteristic, which is the level of trust inherent in the society. As communities rely on association based on trust, and *trust is determined by culture*, it may be said that the general level of trust differs in distinct cultures. In fact, there are many studies in the literature advocating that trust and, particularly, the level of social trust are important determinants of the performance of economies.

The first study known to comprehensively address the effects of mutual trust on the economy is "The Moral Basis of Backward Society", conducted by Banfield and published in 1958. Banfield (1958) attributes the economic backwardness of Southern Italy, in comparison with Northern Italy, to the low general level of trust in the south. Family ties in Southern Italy are very strong, but the other individuals of the society beyond the family exhibit a low level of mutual trust. According to Banfield (1958), the poor general level of trust hampers the communication, cooperation, and interaction between individuals. This prevents the creation of large organizations that would promote economic development. Similarly, La Porta et al. (1997) stated that in large organizations and social structures in which the members interact with each other infrequently, trust was needed to support cooperation. In fact, La Porta et al. (1997) supported this claim by detailing empirical evidence as well.

According to Arrow (1972), the lack of trust plays a significant role in economic backwardness and underdevelopment. Arrow (1972) emphasizes that each commercial transaction relies, in itself, on trust, and that each transaction will definitely come to an end within a given period. Simply, the level of mutual trust is important for the formation of a market. This is because the future involves uncertainty and risk, and economic activities require that economic units trust the future behaviors of others. The linking of supply and demand implies that there has been an explicit or implicit mutual agreement in the background. Economic units that comply with their contracts and thus have gained trust in the market are forced to resort to legal action when the other party fails to comply with the conditions set, which causes significant losses for the complying party in terms of time and money. In other words, the low level of general trust in a society is expected to increase the cost of transactions due to asymmetric information and associated market distortions.