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“Booster” or “blocker”? A study on the effect of cultural diversity on foreign direct investment

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ABSTRACT

In this paper, we investigate the characteristics and mechanisms of cultural diversity that affect foreign direct investment (FDI) using the panel data on provinces in China from 1999 to 2019 and find that, in general, cultural diversity inhibits FDI absorption. However, this kind of adverse effect has a nonlinear threshold characteristic. That is, when the population density reaches a certain level or urbanization is controlled within a certain range, the increase in cultural diversity can weaken the inhibitory effect on FDI. Additionally, by exploring the mechanisms of cultural diversity affecting FDI, we further find that cultural diversity inhibits FDI mainly through the channels of inhibiting population density and urbanization. The conclusions of this paper not only enrich the theoretical research on FDI location from the perspective of cultural diversity but also shed light on how to better attract FDI to China and other countries, such as resolving cultural conflicts and constructing an inclusive investment environment.

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1. Introduction

Over the forty years since China’s reform and opening, foreign direct investment (FDI) has made important contributions to the country’s economic development (Du et al., 2012; Kuntner, 2021; Ma, 2017). FDI not only helps China’s industries address their shortage of funding but also provides strong support for rapid development of China’s economy by using advanced knowledge, technology, and management experience. According to the National Bureau of Statistics of China, in 2019, the amount of imports and exports for foreign-invested enterprises accounts for around 40 percent of China’s trade, and its share of taxes is approximately 18 percent.¹ The rapid development of China’s economy and the continuous improvement of the investment environment have created favorable conditions and circumstances for China to absorb FDI continuously. According to statistics from the World Bank, in 2011 China’s net inward FDI was USD 280.0722 billion, exceeding that of the United States (USD 263.4970 billion) and making China the world’s largest foreign investor for the first

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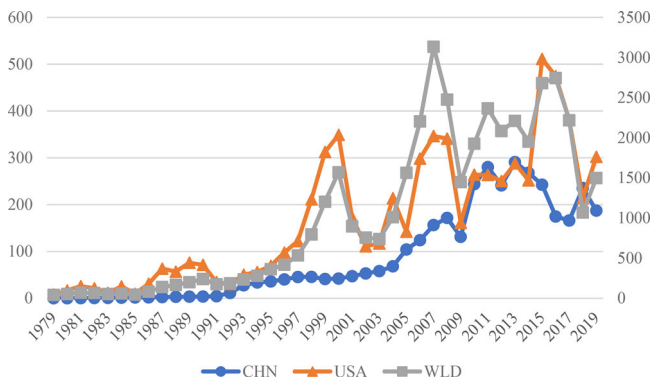


Figure 1. Net FDI inflows (current billion US\$) of the World, United States, and China from 1979 to 2019.

Source: World Bank (<https://data.worldbank.org.cn/>). WLD = world.

time. Since then, the amount of FDI flowing into China has consistently ranked at the forefront in the world even though FDI has decreased in most countries. For example, in Figure 1, the increase in the world's net FDI inflows is negative in 2018, with a decrease of 51.83 percent compared with 2017. In the US, FDI absorption fell 43.72 percent year-on-year in the same period. By contrast, China's net FDI increased 41.71 percent. Why did China maintain a relatively stable increase in FDI absorption? The driving factors behind this phenomenon have attracted widespread attention.

To study the factors affecting the location and distribution of FDI, the existing literature focuses on market size (Alfalih & Hadj, 2020), government policy (Abdalla & Nour, 2014; Choi et al., 2021), exchange rates (Deseatnicov & Akiba, 2016), and so forth, but rarely considers cultural diversity. In the study of FDI location choice, psychological distance—which can be divided into language, education, ethics, culture, and so forth (Johanson & Vahlne, 1977)—is treated as an important non-economic factor that hinders exchanges between the host country and the home country (Beckerman, 1956). As an aspect of psychological distance, cultural diversity usually forms independently and evolves slowly. Therefore, unlike the aforementioned factors that can be characterized by specific indicators, cultural diversity is hard to measure directly from a quantitative perspective, and its ability to affect economic growth or FDI is also difficult to capture.

However, the host country's cultural diversity affects its FDI absorption. On the one hand, diversified culture brings differences in production and lifestyles, which increases demand for commodity trade and squeezes out FDI (Lankhuizen, 2009). On the other hand, diversified culture causes invisible trade barriers, such as language communication, living habits and customs, and degree of trust, which create obstacles to FDI in terms of information communication and business integration (Bailey, 2018; Hergueux, 2011; Konara & Wei, 2014; Mondolo, 2019).

Most of the foreign investment in Chinese mainland comes from Japan, Korea, and Hong Kong (Du et al., 2012). According to the Statistical Bulletin of FDI in China, in 2019, top three sources of investment in mainland China were Hong Kong, Singapore, and South Korea, whose culture is fairly close to Chinese mainland culture. In addition, China's outward FDI also flows to countries or regions with a

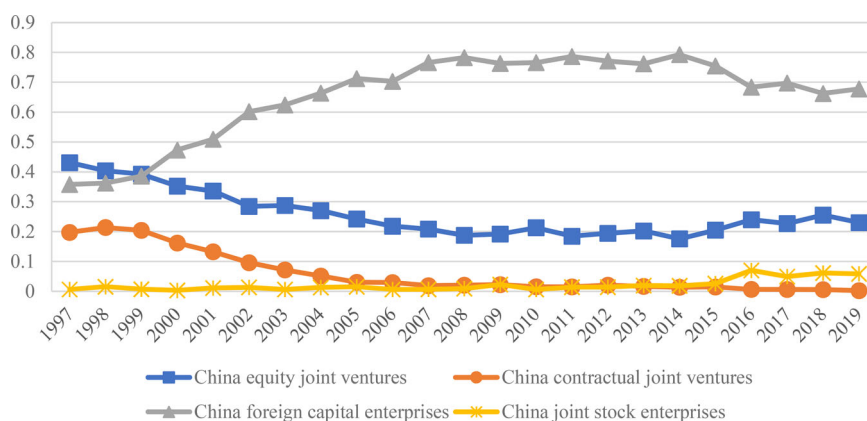


Figure 2. Different types of inward FDI in China from 1997 to 2019.

Source: National Bureau of Statistics of China (<http://www.stats.gov.cn>).

culture to similar to that of China (Buckley et al., 2018). This is mainly because of the important role in these areas played by Confucian culture and the number of overseas Chinese (Clarke & Glinow, 2000; Quer et al., 2012).

Additionally, with growing opportunities for economic cooperation and cultural communication between countries around the world, as a key component of soft power, cultural diversity plays an increasingly vital role in attracting FDI, especially when fully owned enterprises in China dominate the types of firms that absorb FDI (Figure 2). So what happens to inward FDI in China's regions, which have diverse cultures—is it hindered or welcomed? Further, what are the mechanisms in the reaction? We explore these questions in this paper.

Compared to previous studies that mainly focus on the impact of culture on FDI at the national level, this paper investigates the characteristics and mechanisms of cultural diversity that affect FDI absorption from the perspective of various regions in the host country and finds that cultural diversity has a significant inhibitory effect on FDI inflow, and its main impact channels include population density and urbanization level. Moreover, based on a panel threshold model, we argue that increasing human capital and controlling population density can weaken the inhibitory effect of cultural diversity on FDI. Our results not only complement the FDI location choice theory from the perspective of cultural diversity but also shed light on how various countries or regions can better attract foreign investment.

The rest of our paper is organized as follows. Section 2 reviews the relevant literature to clarify our marginal contribution. Section 3 describes our empirical design, including construction of the equations and description of the variables. Section 4 uses a variety of econometric methodologies to examine our research topic. Section 5 concludes the paper and makes some final remarks.

2. Literature review

Briefly speaking, the extant literature about the effect of culture on FDI mainly focuses on the two following aspects.

First, the literature studies the effect of cultural characteristics on the location decision by multinational enterprises. Du et al. (2012) attempt to clarify the relationship between the economic institutions across mainland China and foreign-invested enterprises (FIEs) from different cultural countries or areas and point out that FIEs are culturally remote from unsound institutions. Akhtaruzzaman et al. (2017) argue that cultural institutions have significantly and persistently positive FDI-enhancing effects over time. Demir and Im (2020) demonstrate that the establishment of new Confucius Institutes in African countries is beneficial for the subsequent year's Chinese FDI outflows to Africa. Nayak and Scheib (2020) discuss the cultural logic of German FDI in the service sector. By contrast, Kayalvizhi and Thenmozhi (2018) hold that cultural dimensions, such as individualism, masculinity, and uncertainty avoidance, exhibit a weaker influence on inward FDI for emerging economies.

Second, the literature also concerns the effect of cultural distance on FDI absorption. Zeng et al. (2013) demonstrate that it is important for multinational enterprises (MNEs) to learn foreign cultures, especially when they are at an early stage of expansion in a dissimilar culture. Based on a sample comprising 1,389 acquisitions in India and China, Contractor et al. (2014) show that cultural distance partially affects FDI acquisitions with different types of ownership: full, majority, and minority. Kandogan (2016) investigates the effects of national cultural distance on cross-border FDI and finds that cultural differences play an important role in inhibiting multinationals from developing countries. Bailey (2018) holds that, as an institutional factor, cultural distance as well as tax rates deter FDI attractiveness, which is the opposite of the effects of political stability, democracy, and the rule of law. Kapás and Czeglédi (2020) separate two effects of culture on FDI, i.e., the "level" effect and the "distance" effect, and show that the extant literature overemphasizes the impact of cultural distance on FDI absorption. Some studies argue that the negative relationship between cultural distance and FDI flows can be mitigated by other factors, such as a host country's local demand (Bailey & Li, 2015). By contrast, based on the construction of Thailand's FDI attractiveness index, Changwatchai and Dheera-Aumpon (2020) find that cultural differences do not impede the FDI attractiveness of Thailand.

In sum, the existing literature about culture's effect on FDI mainly pays attention to cultural characteristics such as cultural cognition, cultural distance, and other dimensions by host countries (Czerwonka, 2019; Fang & Wang, 2021; Mondolo, 2019). That is, the existing studies mainly focus on the interrelationship of FDI absorption and cultural differences between countries but ignore the internal composition of a culture in a single economy. Some research on the cultural differences between the host country and the home country focus on the impact of cultural differences on attracting foreign investment from the perspective of language (Konara & Wei, 2014), religion (Hergueux, 2011), history (Gao et al., 2018), law (Steigner et al., 2019), and nationality (Huang et al., 2013). Others focus on individual perspectives, such as the cultural background of managers and investors (Evans & Mavondo, 2002), cultural perception (Li et al., 2017; Vaccarini et al., 2019), and uncertainty avoidance and masculinity (Kayalvizhi & Thenmozhi, 2018; Tang, 2012), to test whether they affect FDI inflows. Notably, Dow et al. (2016) study how the diversity of language and religion within a country affects the ownership structure of foreign

acquisitions, but they mainly pay attention to the impact of cultural diversity on foreign acquisitions, not foreign investment, and use a sample of acquirers, not within-country provinces.

Therefore, relatively few studies concern the role of cultural diversity in FDI absorption. This lacuna gives us the opportunity to make a contribution by demonstrating how cultural diversity influences the effect of FDI absorption. Hence, in this paper, we focus on whether local cultural diversity in China plays a role as a “booster” or a “blocker” in its absorption of FDI. This is mainly because cultural diversity, as an intangible regional factor, plays two roles in attracting FDI.

First, if a region has a diverse culture, it indicates that the region’s culture has a certain degree of inclusiveness, compatibility, and openness (Changwachai & Dheera-Aumpon, 2020). It also means that a region with a higher degree of cultural diversity is more likely to absorb FDI from different cultural backgrounds, which can in turn create a friendly investment environment for foreign investors. Therefore, the barriers to the entry of foreign investors are lower, which is more beneficial for FDI absorption.

Second, a higher degree of cultural diversity implies that people’s lifestyles and thinking patterns in a given local region are more diverse, so it is more likely to cause cultural conflicts (Ma, 2017; Majocchi & Presutti, 2009). That is, when a foreign business invests in a region that is rich in multiple cultures, it has high costs for understanding and acclimating to local culture and customs, especially in conducting in-depth exchanges and long-term cooperation, as friction and conflicts between different types of cultures may become more obvious (Feng et al., 2021). Accordingly, in host countries, cultural diversity has a negative impact on absorption of FDI.

Therefore, in this paper, we investigate the characteristics and mechanisms in cultural diversity that affect FDI absorption in order to clarify the relationship between them and shed light on better FDI absorption in China and other countries.

The main contributions of this paper are as follows. First, unlike previous studies, which mainly focus on the overall evaluation of national culture, this paper reflects cultural diversity at China’s provincial level, which is in line with the connotation of China as a multiethnic country with a rich culture. Second, unlike previous studies that adopt cultural distance to measure cultural differences, this paper employs the dialect diversity in a province to measure its cultural diversity, which more appropriately reflects China’s multicultural characteristics.

3. Empirical design

3.1. Equation

Based on our theoretical analysis, we construct the following empirical equation:

$$\ln fdi_{it} = \alpha + \beta \ln div_i + \gamma \ln X_{it} + \mu_{it}, \quad (1)$$

where fdi represents foreign direct investment, div is cultural diversity, X represents control variables, α , β , and γ are coefficients, μ_{it} is random disturbances, i is a

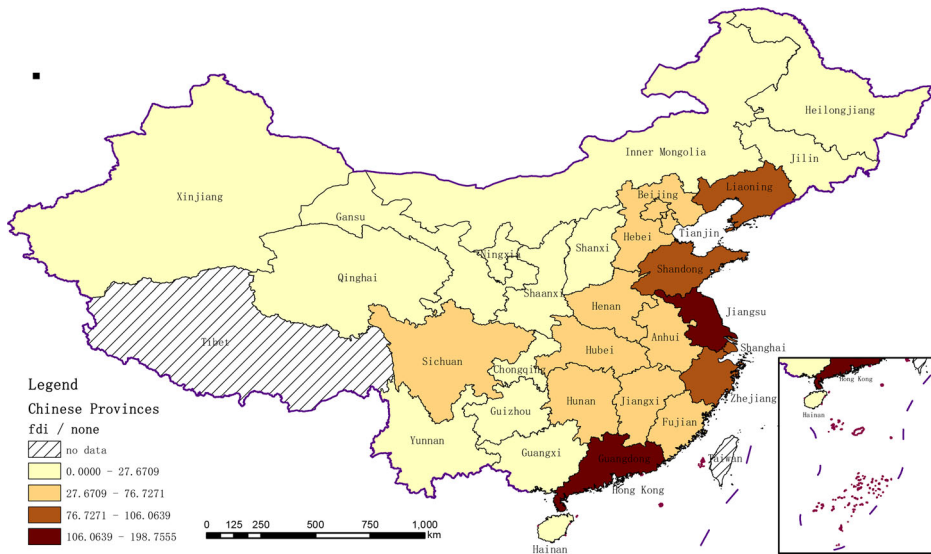


Figure 3. Average spatial distribution of FDI in China, 1999 to 2019.

Source: Drawn by the authors.

province, and t is the year. In order to address heteroskedasticity and possible instability in the regressions, we use a logarithm to calculate each variable.

3.2. Variables

The dependent variable is $\ln fdi$, measured by the amount of disbursed FDI over GDP. Figure 3 shows that the average amount of FDI absorption in provinces from 1999 to 2019 takes a declining spatial pattern from east to west in China.

The independent variable is cultural diversity (div). We use the data on the amount of dialect diversity and the number of Chinese dialects as a measurement of cultural diversity.² That is, cultural diversity index 1, div_1 , is averaged by the dialect diversity in cities in a province and cultural diversity index 2, div_2 , is summed up by the number of dialects in cities in each province. It implies that a larger value of div_i ($i=1, 2$) means a higher degree of cultural diversity. Why do we employ dialect diversity to stand for cultural diversity? The reasons are as follows.

In China, over its long historical evolution, unique local dialects developed in various regions.³ As an important reflection of regional culture, dialects have an inherent consistency with culture because people who speak different dialects often have distinctive behavioral patterns (Chen, 2013). People who grow up and live in a specific dialectic environment are deeply influenced by its cultural imprint. Therefore, it is reasonable to measure a region's cultural diversity from the perspective of dialects (Feng et al., 2021).

Furthermore, we explore how cultural diversity measured by dialects affects FDI. The mechanism is that the decision to invest in China is affected by the effectiveness of communication between multinational companies and Chinese local enterprises, especially when foreign investors have a long-term plan to do business in China.

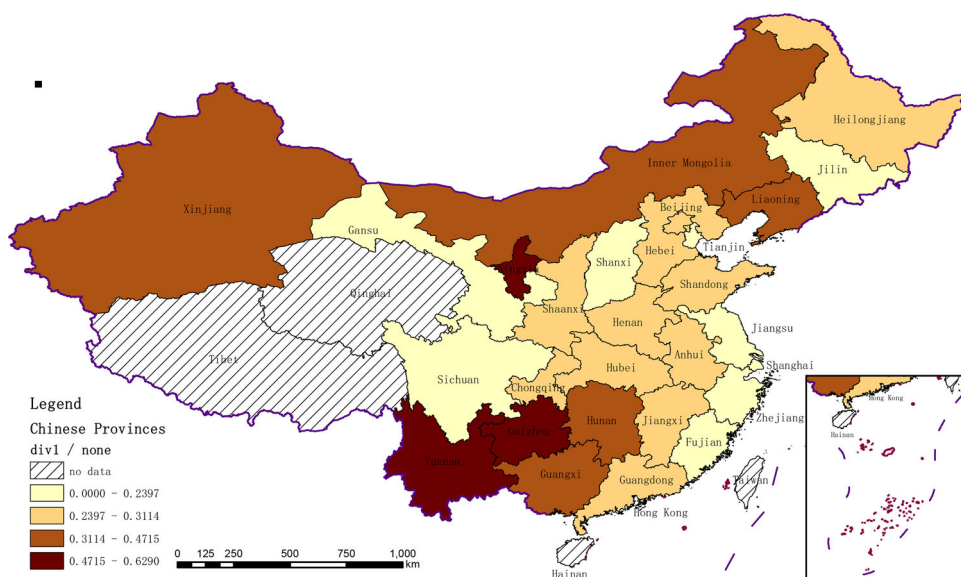


Figure 4. Geographic distribution of cultural diversity in China.

Source: Drawn by the authors.

Therefore, if diverse dialects are spoken in a region, it implies that it has different kinds of cultural diversity, which not only increase the communication cost for foreign businesses in understanding local culture but also affect the degree of trust between business partners (Feng et al., 2021; Pendakur & Pendakur, 2002;). People with different cultural backgrounds tend to have different thinking habits and behavior patterns, so cultural diversity increases the difficulty of trusting and understanding among investors, and it can affect long-term sustainable cooperation between foreign enterprises and local companies.

Figure 4 shows the spatial distribution of cultural diversity in various regions in China. It indicates that regions with more cultural diversity are mainly located in central and western China. The reason for this phenomenon is that many ethnic minorities who live in these areas speak their own language or have their own writing system. For example, according to the National Bureau Statistics of China, 51 ethnic minority groups live in Yunnan Province, 48 in Guizhou Province, and 55 in Sichuan Province. Therefore, having more dialects leads to more cultural diversity.

We include some control variables in order to construct stabler and more robust regressions, following the relevant literature (Boermans et al., 2011; Campos & Kinoshita, 2003; Feng et al., 2021; Tabellini, 2010): human capital (*hr*), which is measured by weighted years of education; government participation (*gov*), which is measured by the proportion of government expenditure in each province to its GDP; infrastructure (*infra*), which is expressed as the proportion of the total fixed capital of each province to its GDP; financial development (*fe*), which is characterized by the proportion of the value added of the finance industry in each province to its GDP; market size (*mdemand*), which is constructed by Harris (1954); and economic vitality (*entre*), which is calculated by the proportion of employment in individual and private enterprises in each province to its total population.

Table 1. Descriptive statistics of the variables.

	Mean	Standard deviation	Min	max	p25	Median	p75	t-value
<i>lnfdi</i>	-3.9913	1.0440	-7.7875	-1.7139	-4.5045	-3.8964	-3.3365	-92.7081
<i>lndiv₁</i>	-1.3644	0.7280	-4.3734	-0.4636	-1.4775	-1.2961	-0.9803	-45.4432
<i>lndiv₂</i>	2.5477	0.9201	0.0000	3.5264	2.1242	2.9701	3.1133	67.1471
<i>lnentre</i>	-2.2037	0.6711	-3.8617	-0.4663	-2.6746	-2.2281	-1.7367	-79.6251
<i>lnhr</i>	2.1459	0.1261	1.7612	2.5480	2.0644	2.1487	2.2223	412.6767
<i>lngov</i>	-1.6083	0.4098	-2.6690	-0.7055	-1.9256	-1.6079	-1.3315	-95.1655
<i>lninfra</i>	-0.4638	0.4554	-1.4982	0.4445	-0.8532	-0.4596	-0.0698	-24.7008
<i>lnfe</i>	-2.9534	0.4951	-4.6598	-1.6302	-3.3242	-2.9717	-2.6135	-144.6433
<i>lnmdemand</i>	-3.415	0.9207	-5.9896	-1.3977	-4.1378	-3.3394	-2.6951	-89.9443

Source: Authors' calculation.

Table 2. Variance inflation factor.

Variables	VIF	1/VIF	VIF	1/VIF
<i>lndiv₁</i>	1.55	0.6470	<i>lndiv₂</i>	1.76
<i>lnentre</i>	3.82	0.2618	<i>lnentre</i>	3.80
<i>lnhr</i>	2.59	0.3859	<i>lnhr</i>	2.80
<i>lngov</i>	2.19	0.4573	<i>lngov</i>	2.14
<i>lnfe</i>	2.30	0.4346	<i>lnfe</i>	2.73
<i>lninfra</i>	2.54	0.3932	<i>lninfra</i>	2.38
<i>lnmdemand</i>	3.84	0.2604	<i>lnmdemand</i>	4.15
Mean VIF	2.69		Mean VIF	2.82

Source: Authors' calculation.

3.3. Data

The data that follow mainly come from the *China Statistical Yearbook* and the *Statistical Bulletins on National Economic and Social Development*. Due to the lack of data on Tibet, Qinghai Province, and Hainan Province, the final sample consists of 28 provinces in China from 1999 to 2019. [Table 1](#) describes the statistics of each variable. It shows that the standard deviations of these variables are controlled within nearly 1, which indicates that the distribution of the full sample is relatively concentrated.

Moreover, we examine whether collinearity exists between these variables. According to the variance inflation factor (VIF) reported in [Table 2](#), all the VIF values are less than 10, which indicates the absence of collinearity between the variables.

4. Empirical analysis

4.1. Baseline regression

Because cultural diversity is a point-in-time variable, according to the empirical methodology for panel data (Woolridge, 2011), we use a random-effects model (RE) to regress the relationship between cultural diversity (*lndiv_i*) and FDI. The results are reported in columns (1) and (3) of [Table 3](#), which indicate that the impact of cultural diversity on FDI is significantly negative, consistent with our expectation. Second, to address heteroskedasticity in regressions, we use the generalized least squares (GLS) methodology to perform further examinations. Based on the results reported in columns (2) and (4) of [Table 3](#), the coefficients of cultural diversity on FDI are still significant and negative, which confirm our expectations again.

Table 3. Regression results based on random-effects (RE) and generalized least squares (GLS) methods.

	(1) Infdi RE	(2) Infdi GLS	(3) Infdi RE	(4) Infdi GLS
<i>Indiv</i> ₁	-0.8247*** (0.1641)	-0.2360*** (0.0542)		
<i>Indiv</i> ₂			-0.5035*** (0.1307)	-0.3485*** (0.0441)
<i>Inentre</i>	-0.3013*** (0.0834)	-0.2167** (0.0924)	-0.3318*** (0.0844)	-0.2065** (0.089)
<i>Inhr</i>	-0.1738 (0.6253)	3.9041*** (0.4049)	-0.3094 (0.6422)	3.1275*** (0.4070)
<i>Ingov</i>	-0.1867 (0.1816)	-1.6419*** (0.1145)	-0.4394** (0.1795)	-1.7548*** (0.1094)
<i>Infe</i>	-0.3872*** (0.0878)	-0.1576 (0.0972)	-0.419*** (0.0899)	-0.4301*** (0.1023)
<i>Ininfra</i>	0.6634*** (0.0872)	0.4853*** (0.1111)	0.6679*** (0.0882)	0.4327*** (0.1038)
<i>Inmdemand</i>	-0.0324 (0.0985)	0.3091 (0.0675)	0.0878 (0.1019)	0.2307*** (0.0678)
Constant	-6.6543*** (1.5694)	-15.9162*** (1.0892)	-4.1107** (1.7107)	-13.3741*** (1.0911)
Observations	588	588	588	588
R ²	0.2531	-	0.2386	-

Notes: The values in parentheses are standard errors; *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Source: Authors' calculation.

Notably, in the regressions of control variables, we find that, other than financial development (*Infe*) and economic vitality (*Inentre*), the results of the variables are consistent with our expectations. The main reasons are as follows. First, the development of China's international financial business is not sound enough to provide effective and convenient services for FDI absorption. Second, due to the weak financial and institutional support for the development of individual and private enterprises in China, the economic vitality is not yet sufficient to become a positive factor in attracting FDI (Boermans et al., 2011; Jiang et al., 2010).

4.2. Considering endogeneity

In the process of cultural diversity affecting FDI, the continuous FDI absorption also causes and promotes the integration of regions with diverse cultures and gradually creates a common cultural identity (Jiang et al., 2010). In this regard, we look at examples such as Shanghai, Suzhou, and Guangzhou in China. When these cities receive a large amount of FDI, to facilitate communication, people from all over the country use a common language, such as Mandarin or English, so their local dialects gradually fall into disuse. Therefore, cultural diversity is endogenous in the process of affecting FDI absorption, so we employ instrumental variables (IV) to address this regression bias.

First, we introduce the slope of each province as a geographic IV (*IV*₁). Terrain plays an important role in the formation and evolution of local culture. In general, the rockier the land surface, the higher the slope, and the easier it is for a region to be divided into small areas that are independent or even isolated. This facilitates the emergence of unique dialects and diverse cultures. However, the biggest motivation for FDI is to earn profits.

Table 4. Regression results based on the instrumental variable (IV) method.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	<i>lnfdi</i> RE-IV ₁	<i>lnfdi</i> RE-IV ₂	<i>lnfdi</i> RE-IV ₁	<i>lnfdi</i> RE-IV ₂	<i>lnfdi</i> GMM-IV ₁	<i>lnfdi</i> GMM-IV ₂	<i>lnfdi</i> LIML-IV ₁	<i>lnfdi</i> LIML-IV ₂
<i>Indiv</i> ₁	-0.8159*** (0.1329)	-2.215*** (0.8287)			-0.8159*** (0.1384)	-2.215*** (0.7594)	-0.8159*** (0.1384)	-2.215*** (0.7594)
<i>Indiv</i> ₂			-0.7946*** (0.1240)	-0.8239*** (0.1802)				
Control variables	YES	YES	YES	YES	YES	YES	YES	YES
K-P LM	116.626***	8.214***	87.482***	42.242***	25.997***	11.662***	25.997***	11.662***
K-P Wald F	143.501***	8.217***	101.373***	44.893***	49.424***	12.755***	49.424***	12.755***
Hansen J	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Observations	588	588	588	588	588	588	588	588
R ²	0.3515	0.7750	0.4054	0.3935	0.3515	0.7750	0.3515	0.7750

Notes: Values in parentheses are standard errors; *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Source: Authors' calculation.

Therefore, if the return on investment is large enough, these investors do not care about the impact of terrain and topography. For example, the Silk Road has difficult terrain, but this does not prevent businessmen from traveling it to pursue profit.

Second, we measure the convenience of rail transportation, which is the sum of the reciprocal of the distance from one provincial capital to another before the founding of the People's Republic of China in 1949 as a historical IV (IV₂) as a sign of cultural diversity.⁴ It indicates that when a region has a higher degree of spatial connectivity, it is more likely to have dialect interaction and cultural integration. Nevertheless, the convenience of a region in the domestic market has no direct impact on the location of FDI. As shown in Figure 1, FDI is mainly distributed in eastern China, primarily due to its geographic advantages, such as proximity to foreign markets, not the spatial connection between the eastern region and other regions. Moreover, the convenience of rail transportation before 1949 mainly grew out of the needs of the military, rather than to improve local infrastructure for FDI absorption.

Accordingly, we employ a random-effects model with IVs (RE-IV) for regressions. The results are presented in Table 4, showing that the effects of cultural diversity on FDI are significantly negative at the 1% level. Meanwhile, to further check the robustness of these results, we conduct further regressions with the cultural diversity index 1 (*Indiv*₁) as an example and use the generalized method of moments (GMM) and the limited-information maximum likelihood (LIML). The results are listed in columns (5) to (8) of Table 4, in which all three regression coefficients of cultural diversity are still significantly negative at the 1% level. This confirms the robustness of our results as well as our expectations.

4.3. Time-effects regression

The extent of cultural diversity decreases because of continuous communication between people and cultural integration (Lane et al., 2001; Prashantham & Floyd, 2012; Zeng et al., 2013). Therefore, it is necessary to investigate the time effect of cultural diversity on FDI.

Table 5. Regression results of time effects.

	(1) RE	(2) RE-IV ₁	(3) RE-IV ₂	(4) RE	(5) RE	(6) RE
$\ln(\text{div}_1/t)$	-0.0462 (0.088)	-2.5959*** (-5.14)	-2.5691*** (-3.72)		-0.4235** (0.1818)	
$(\ln(\text{div}_1/t))^2$					-0.1203** (0.0507)	
Indiv_1				-1.7369*** (0.5877)		-0.3880** (0.1804)
$(\text{Indiv}_1)^2$				-0.1943 (0.1209)		
t						-0.1921*** (0.0288)
$t \times \text{Indiv}_1$						0.0134 (0.012)
$t^2 \times \text{Indiv}_1$						-0.0012** (0.0005)
Control variables	YES	YES	YES	YES	YES	YES
K-P LM		52.630***	27.894***			
K-P Wald F		57.017***	28.884***			
Hansen J		0.000	0.000			
Observations	588	588	588	588	588	588
R ²	0.2390	0.0751	0.0836	0.2579	0.2490	0.2823

Notes: Values in parentheses are standard errors; *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.

Source: Authors' calculation.

First, we examine this effect based on the passage of time. We introduce div_1 divided by year ($\ln(\text{div}_1/t)$) to the regression equation and employ the methodologies of RE and RE-IV. The results are presented in columns (1) to (3) of Table 5, in which the results are still significantly negative, indicating that even over time, cultural diversity has a restraining effect on FDI absorption.

Second, we investigate whether cultural diversity has a nonlinear characteristic during the process of attracting FDI. For example, we add the square term of Indiv_1 ($(\text{Indiv}_1)^2$) to the regression equation. The results are reported in column (4) of Table 5, showing that the coefficient of $(\text{Indiv}_1)^2$ is negative, which implies that the relationship between cultural diversity and FDI might take an inverted U-shape. In order to further check the significance of this characteristic, we introduce the square term of cultural diversity divided by year, i.e., $(\ln(\text{div}_1/t))^2$, to perform the regressions again. Moreover, t and t^2 , i.e., $t \times \text{Indiv}_1$, and $t^2 \times \text{Indiv}_1$, are also introduced to the regressions. The results are reported in columns (5) to (6) of Table 5, showing that the squared terms in these regressions are all negative and significant, which implies that the inhibitory effect of cultural diversity on FDI is nonlinear. Accordingly, we infer that if cultural diversity is too high, that is, the value of cultural diversity exceeds the inflection point, it will impede FDI absorption. However, if cultural diversity is moderate, that is, the value of cultural diversity does not exceed the inflection point, it is beneficial for absorbing FDI.

4.4. Threshold regression

The regressions above document that only moderate cultural diversity plays a positive role in attracting FDI. As a consequence, we should ask which factors affect this

nonlinear characteristic and what their threshold values are. Hence, we employ a panel threshold model to investigate these questions.

First, we construct a threshold model with panel data. If the threshold variable has only one threshold value, the empirical equation is constructed as follows:

$$\ln fdi_{it} = \alpha_0 + \beta_1 \ln div_i \times I(g_{it} \leq \tau_1) + \beta_2 \ln div_i \times I(g_{it} > \tau_1) + \gamma x_{it} + \varepsilon_{it}, \quad (2)$$

But if there are two threshold values, the regression equation can be constructed as follows:

$$\begin{aligned} \ln fdi_{it} = & \alpha_0 + \beta_1 \ln div_i \times I(g_{it} \leq \tau_1) + \beta_2 \ln div_i \times I(\tau_1 < g_{it} \leq \tau_2) + \beta_3 \ln div_i \\ & \times I(g_{it} \\ & > \tau_2) + \gamma x_{it} + \varepsilon_{it}, \end{aligned} \quad (3)$$

where g_{it} is the threshold variable, τ_j is the threshold value, and the description of other variables is the same as in [equation \(1\)](#).

Second, we select some threshold variables based on the extant literature (Bisin & Verdier, 2014; Feng et al., 2021; Kuntner, 2021). On the one hand, we hold that if a region is rich in different cultures, it means that the regional openness is not high, and each region is disinclined to trade or do business with other regions. This characteristic can be captured from the geographic distribution of China's cultural diversity in [Figure 4](#). It demonstrates that regions with higher cultural diversity are mostly located in the central or western regions, especially in southwestern and northwestern China, where many ethnic minorities reside. However, the extent of openness affects a region's ability to obtain spillovers from outside and further generate an effect on its accumulation of human capital, which is critical for multinational companies to decide whether to invest in this region.

On the other hand, cultural diversity affects the agglomeration of the population. This is mainly because higher cultural diversity can more easily cause collective conflicts, which originate in diverse values and sense of identity. Thus, it further hinders the increase in population density and the process of urbanization. By contrast, if a region exhibits higher cultural diversity, it might also imply that the region is more inclusive or receptive, which can better stimulate population movement. These factors tend to increase the region's population density and urbanization and affect the accumulation of FDI.

Consequently, we use human capital, population density, and urbanization as threshold variables to examine whether the effect of cultural diversity on FDI relies on these variables. First, we need to identify how many threshold values each threshold variable has. The regression results are reported in [Table 6](#), showing that when the threshold variable is urbanization (*lnurban*), there is no threshold value. However, when the threshold variable is human capital (*lnhr*), there is only a single threshold. Meanwhile, when the threshold variable is population density (*lndensity*), a double threshold.

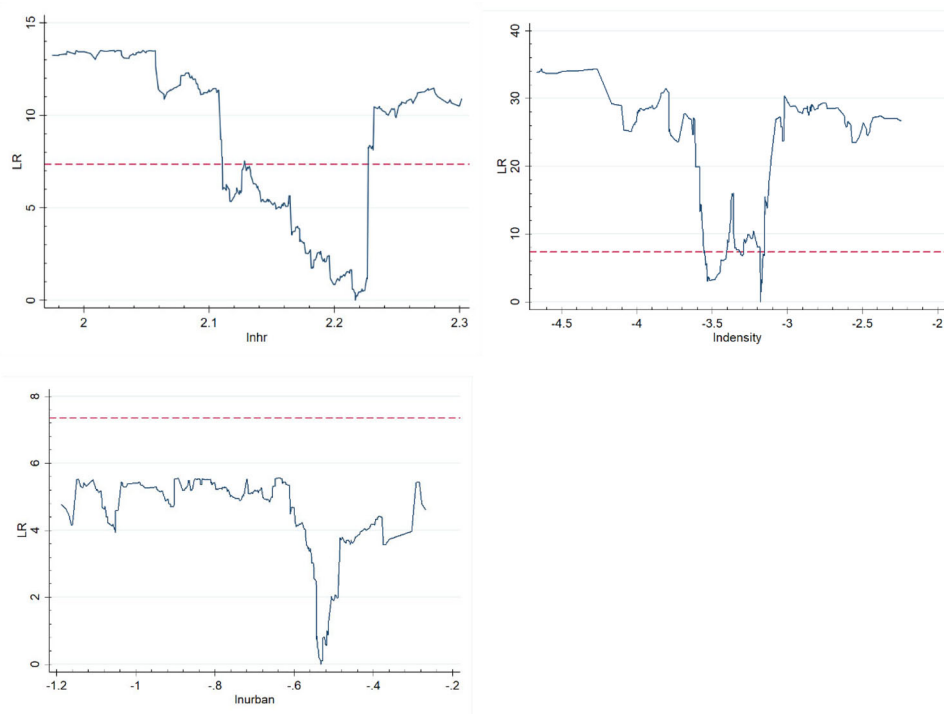
Second, we illustrate the likelihood ratio (LR) to display the distribution of threshold variables more intuitively. In [Figure 5](#), other than for urbanization (*lnurban*), the

Table 6. Panel threshold analysis.

Threshold variable	Threshold type	F-value	P-value	Threshold value	95% confidence interval
<i>lnhr</i>	Single threshold	13.500*	0.082	2.217	[2.111, 2.226]
	Double threshold	4.070	0.310	2.009	[1.975, 2.302]
	Triple threshold	0.000*	0.088	2.050	[2.049, 2.301]
<i>Indensity</i>	Single threshold	32.485***	0.000	-3.682	[-3.897, -3.616]
	Double threshold	34.394**	0.022	-3.177	[-3.554, -3.153]
	Triple threshold	-4.138	0.372	-3.177	[-3.323, -2.243]
<i>lnurban</i>	Single threshold	5.397	0.250	-0.533	[-1.188, -0.269]
	Double threshold	11.533*	0.086	-0.668	[-1.188, -0.596]
	Triple threshold	0.000*	0.092	-0.601	[-0.620, -0.278]

Notes: ***, **, and * represent significance at 1, 5, and 10 percent, respectively. Both p and critical values are simulated 500 times by the bootstrap method.

Source: Authors' calculation.

**Figure 5.** Likelihood ratio (LR) graphs of the threshold values.

Source: Drawn by the authors.

threshold variables have threshold values, which is consistent with the results in Table 6.

Accordingly, we employ a threshold model with panel data to examine the characteristics of each threshold variable. The results are reported in Table 7. On the one hand, we investigate the characteristic of the threshold variable human capital (*lnhr*), which shows that if the value of *lnhr* is less than 2.217, the coefficient of cultural diversity is -0.1878 . Meanwhile, when the value of *lnhr* exceeds 2.217, the coefficient of cultural diversity is 0.1396 , but it does not pass the significance level of at least 10%; this implies that the negative effect of cultural diversity on FDI gradually

Table 7. Threshold regression results.

	(1)	(2)	(3)	(4)
	<i>lnfdi</i>	<i>lnfdi</i>	<i>lnfdi</i>	<i>lnfdi</i>
	<i>lnhr</i>		<i>Indensity</i>	
	RE	RE_Robust	RE	RE_Robust
$\ln(\text{div}_i/t)$	0.1396 (1.20)	0.1396 (1.09)	-0.0255 (-0.30)	-0.0255 (-0.18)
β_1	-0.3274** (-2.34)	-0.3274* (-1.78)	0.1800*** (5.29)	0.1800** (2.39)
β_2			0.0502 (1.07)	0.0502 (0.93)
Control variables	YES	YES	YES	YES
Adjust-R ²	0.2632	0.2632	0.2754	0.2754
Observations	588	588	588	588

Notes: Values in parentheses are t-values; *, **, and *** indicate significance at 10%, 5%, and 1%, respectively.
Source: Authors' calculation.

weakens when human capital surpasses a certain critical value. The reason is that higher human capital represents a higher level of education, which not only endows individuals with language ability and communication skills for cross-cultural communication, but also helps to increase individuals' understanding and respect for different cultures. At the same time, high-tech-oriented FDI usually regards the quality of talent in the host country as a priority in its investment choice. Therefore, higher human capital can weaken the inhibitory impact of cultural diversity on attracting FDI.

On the other hand, we explore the characteristic when the threshold variable is population density (*Indensity*). As seen in Table 7, when the value of *Indensity* is less than -3.682, the coefficient of cultural diversity is 0.1545. However, when the value of *Indensity* is in the range [-3.682, -3.177], the coefficient of cultural diversity is 0.2047. Additionally, when the value of *Indensity* is greater than -3.177, the coefficient of cultural diversity is -0.0255. This implies that lower population density is conducive to cultural diversity, which is beneficial to absorbing FDI. The reason might be that when the population density is controlled within a certain range, cultural diversity plays an inclusive and receptive role in diversity. However, increasing population density can generate more potential or chances for confrontation between different types of cultures and create conflicts, which is detrimental to creating a stable environment for attracting FDI (Feng et al., 2021).

4.5. Mechanism discussion

The earlier sections explore the inherent characteristics of cultural diversity that affect FDI absorption. Now, we ask how cultural diversity affects FDI or through which channels cultural diversity inhibits FDI. Consequently, we use a mediation model (Hayes, 2017; Mackinnon, 2008) to investigate the mechanisms through which cultural diversity affects FDI.

First, we construct a mediation model as follows:

$$\ln fdi_{it} = \alpha_1 + \beta_1 \ln div_i + \gamma_1 x_{it} + \varepsilon_{it}, \quad (4)$$

$$\ln mv_{it} = \alpha_2 + \beta_2 \ln div_i + \gamma_2 x_{it} + \varepsilon_{it}, \quad (5)$$

$$\ln fdi_{it} = \alpha + \beta_3 \ln div_i + \theta_3 \ln mv_{it} + \gamma_3 x_{it} + \varepsilon_{it}, \quad (6)$$

where the coefficient β_1 represents the total effect of cultural diversity on FDI; the coefficient β_2 is the partial effect of cultural diversity on mediating variables, i.e., $\ln mv_{it}$; β_3 is the direct effect of cultural diversity on FDI; and $\beta_2 \times \theta_3$ measures the indirect effect of cultural diversity on FDI.

Accordingly, first, we investigate the mechanism using human capital ($\ln hr$) as a mediating variable. The regression results are reported in columns (1) to (3) of Table 8, which shows that because the coefficient of $\ln div_i$ in column (2) does not exceed the 10% significance level, nor does the coefficient of $\ln hr$ in column (3), the requirements of the mediation model are not satisfied. This means that human capital is not the precise mechanism that affects the impact of cultural diversity on absorbing FDI. The reason might be that in a region with a more diverse culture, its prominent individual and regional characteristics show more. However, the overall education system in China's provinces has difficulty in meeting the needs of personalized talent development. Therefore, cultural diversity has an insignificant negative impact on human capital.

Second, we employ population density ($\ln density$) as a mediating variable to explore the mechanism through which cultural diversity affects FDI. The regression results are reported in columns (4) to (6) of Table 8, showing that population density has a partial mediating effect on the mechanism through which cultural diversity affects FDI. The value of the mediating effect is -0.1733 , and the contribution rate is 21.5023%. This implies that cultural diversity affects FDI absorption partly through the channel of inhibiting population density. This is mainly because higher population density not only brings richer labor reserves and more intensive intellectual contact to FDI, but also generates a larger market size for FDI. However, cultural diversity in a region can yield differentiated value orientation and customs, which is not conducive to population agglomeration. Thus, it weakens the promotional effect of population density on FDI.

Finally, we use urbanization ($\ln urban$) as the mediating variable for investigation. The results reported in columns (7) to (9) of Table 8 show that because the regression results of the main coefficients are all statistically significant at the 1% level, the mechanism induced by urbanization has a partial mediating effect. The value of the mediating effect is -0.0771 , and its contribution rate is 15.5661%. That is, cultural diversity also inhibits FDI absorption partly through the channel of hindering urbanization. The main reason is that a higher level of urbanization means better social infrastructure, which is the material basis for attracting FDI. However, cultural diversity in a region can generate differentiated cultural ideas, lifestyles, and religious beliefs, which leads to inefficient production and living standards and inhibits the construction of social public infrastructure. This is not conducive to urbanization and further influences the willingness of foreign investors to invest in China.

Table 8. The regression results of the mediation model.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
<i>Indv₁</i>	<i>Infdi</i> -0.4858*** (-3.34)	<i>Inhr</i> -0.0284 (-1.36)	<i>Infdi</i> -0.4956*** (-3.50)	<i>Infdi</i> -0.8247*** (-5.03)	<i>Indensity</i> -0.5359*** (-2.98)	<i>Infdi</i> -0.6757*** (-1.63)	<i>Infdi</i> -0.4956*** (-3.50)	<i>Inurban</i> -0.0861** (-3.18)	<i>Infdi</i> -0.4036** (-3.17)
<i>Inhr</i>			-0.4138 (-0.65)						
<i>Indensity</i>						0.3309*** (3.72)			
<i>Inurban</i>									0.8960*** (5.06)
Control variables	YES	YES	YES	YES	YES	YES	YES	YES	YES
Bootstrap (95% CI)	[-0.0988, -0.0298]								
Mediating effect		-		-0.1733			-0.0771		
Contribution				21.5023%			15.5661%		
Adjust-R ²	0.2061	0.3256	0.1956	0.2531	0.2484	0.2664	0.1956	0.6939	0.3408
Wald chi2	101.49***	3419.19***	102.13***	169.80***	68.55***	188.77***	102.13***	997.26***	133.60***
Observations	532	532	532	588	588	588	532	532	532

Notes: Values in parentheses are t-values; *, **, and *** indicate significance at 10%, 5%, and 1%, respectively. 95% CI stands for 95% confidence interval. Source: Authors' calculation.

5. Discussion

Does cultural diversity play a role as a “booster” or “blocker” in the absorption of FDI? This paper studies the impact and mechanism of cultural diversity in China’s provinces on attracting FDI. The results show that cultural diversity is a “stumbling block” for absorbing FDI, and the main mechanism is that cultural diversity hinders FDI by inhibiting population density and urbanization. In addition, this paper also finds an inverted-U-shaped relationship between cultural diversity and FDI absorption, which means that moderate cultural diversity is conducive to FDI inflow, while excessive cultural diversity inhibits FDI absorption. This is mainly because low cultural diversity in a region means that people with few cultural differences can gather together to enhance ideological exchange (Changwatchai & Dheera-Aumpon, 2020; Dow et al., 2016), stimulate innovation vitality, and further make the region the first site choice for FDI (Feng et al., 2021). By contrast, high cultural diversity in a region means that the region has some cultural collisions and even conflicts (Ma, 2017; Majocchi & Presutti, 2009), which leads to stagnation in economic development and social order and makes foreign investors reluctant to become involved there. This suggests that local governments should pay attention to cultural communication within their jurisdiction, strive to alleviate cultural conflicts, and make residents with different cultural backgrounds appreciate the values of others as much as their own, so as to create a harmonious and stable social environment for FDI inflow.

Unlike previous studies that focus mainly on the impact of cultural distance between countries on FDI absorption (Bailey, 2018; Contractor et al., 2014; Kandogan, 2016; Kapás & Czeglédi, 2020), this paper examines the impact on FDI inflow of cultural diversity in provinces within a country. Additionally, the main innovation in this paper is in measuring cultural diversity by the number of dialects and dialectical diversity and introducing two IVs—geographical slope and convenience of rail traffic to mitigate endogeneity in the regression.

However, this paper has some limitations. For example, because the lack of micro-individual data on cultural diversity and foreign investment, it is difficult for us to perform a deeper exploration of the micro-mechanism and direction of evolution in cultural diversity affecting FDI.

Accordingly, further research is recommended to achieve a more comprehensive picture by considering these limitations. First, by investigating the characteristics of cultural diversity at the individual level, this paper attempts to reflect the connotation of cultural diversity in a region more carefully and explore the evolution of cultural diversity in attracting FDI under the background of increasingly cultural blending. Second, this paper also tries to focus on the impact of cultural conflicts caused by individual cultural differences in different countries on the willingness of home countries to invest outwards and host countries to attract inward FDI. It aims to provide a more solid micro-foundation for transnational investment from the perspective of cultural blending.

6. Conclusions

Using data on 28 provinces in China from 1999 to 2019, we employ various econometric methodologies to capture the characteristics and mechanisms of cultural diversity affecting FDI. The conclusions are as follows. In general, cultural diversity has an

adverse effect on absorbing FDI, but this hindering effect takes an inverted-U shape, which means that if the population density reaches a certain threshold or urbanization is controlled within a certain range, an increase in cultural diversity is conducive to weakening the inhibitory effect on the attraction of FDI. Furthermore, we investigate the mechanisms through which cultural diversity affects FDI and find that cultural diversity hinders FDI absorption mainly through the channels of inhibiting population density and urbanization.

Overall, our conclusions not only enrich the theoretical research on the potential and sustainability of absorbing FDI from the perspective of cultural diversity, but also provide enlightenment for China or other countries that want to attract FDI. For example, in absorbing FDI, it is necessary to pay attention to the role of cultural diversity and respect the habits and customs of others. Meanwhile, we should also seek common ground and respect differences during the process of FDI absorption. Particularly in long-term investment and international cooperation, it is advisable to offer an inclusive and acceptable cultural environment for foreign investors and avoid cultural conflicts. Additionally, we should improve human capital, increase the urbanization level, and control population density to weaken the inhibitory effect of cultural diversity on FDI absorption.

Notes

1. National Bureau of Statistics of China (<http://www.stats.gov.cn>).
2. We thank Professor Xianxiang Xu at Lingnan College, Sun Yat-sen University, Guangzhou, P. R. China, who shared the dialect diversity data with us.
3. According to the *Dictionary of Chinese Dialect and Chinese Language Atlas*, China has 17 dialects and 105 subdialects. The 17 dialects are Beijing Mandarin, Northeast Mandarin, Jilu Mandarin, Jianghuai Mandarin, Jiaoliao Mandarin, Central Plains Mandarin, Yinlan Mandarin, Southwest Mandarin, Gan dialect, Jin dialect, Hui dialect, Wu dialect, Min dialect, Xiang dialect, Cantonese, Hakka dialect, and Pinghua dialect (in areas along the rail lines and rivers in Guangxi).
4. We use the map named “China Railway Distribution Map from 1878 to 1948,” in *Modern Railway Construction in China* to construct the index for transportation convenience in provincial capitals before 1949. It is expressed as the sum of the average distance from each provincial capital to the nearest three or four cities on the same railway line. Therefore, the higher the index, the more convenient the transportation is in the area.

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Author contributions

All authors are involved in writing the manuscript and have all proved the submitted form.

Data availability statement

The data that support the findings of this study are available on request from the corresponding author. The data are not publicly available due to privacy or ethical restrictions.

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