Chapter 2: Literature Review

2.1 Introduction

The increment in FDI flows in recent decades has encouraged a great deal of research into the phenomenon of multinational companies (MNCs). A large number of theories have been developed after World War II to explain FDI and international production. These theories find out a number of determinants that could explain FDI flows into particular location, linking the micro aspect like firm specific aspects e.g. ownership advantage, cost reduction and economies of scale and macro aspects like market size, natural resource availability, barriers to entry and institutional quality etc. (Dunning and Lundan, 2008; Faeth, 2009). A large number of empirical literatures on FDI have recognized an extensive list of determinants that try to explicate investment made by MNCs in a particular location but there is no common agreement insofar with most of the determinants of FDI inflows as few studies have not found any statistically significant relation with respect to certain determinates (Assunção, 2011). In this context, the current chapter reviews the key theoretical approaches to FDI and empirical studies to identify which factors have been found to be most robust in terms of attracting FDI to a specific location, and so enlighten the geographic distribution of FDI. Since this study intends to spot out factors that have been found to best explain FDI inflows to a particular location, this study focuses on the macro dimension of FDI determinants.

This chapter is organized as follows. Section 2.1 briefly describes various theoretical explanations that have been used to explain FDI flows over the years in the world. Section 2.2 identifies the empirical studies with respect to location determinants of FDI. The chapter further identifies the gaps in existing literature and covers the objective of the study, in Section 2.3 and 2.4 respectively.
2.2. Theoretical Literature

2.2.1 Background

Growth in FDI flows after the World War II has inspired many researcher to understand the behavior of MNCs and determinants of FDI, particularly the remarkable increase in FDI from the U.S owned companies to Western Europe which has given rise to the questions, as to why US MNCs are investing abroad instead of exporting in these markets from the home market, how can U.S MNCs compete with already existing domestic firms of Europe and why instead of licensing their ownership advantage U.S MNCs made investment in Europe. These questions have motivated many researchers to explain the International production. Many studies have been conducted to find the answer of this question.

A number of attempts have been made by different academicians and researchers to present the review of FDI theories in different time periods (Agarwal, 1980; Mainardi 1987; Lizondo, 1991; Rayome and Baker, 1995; Denisia, 2010; Assuncao et.al, 2011; Choudhury and Nayak; 2014). Some of the important studies in this regard are discussed below.

The initial explanation of FDI were based on the trade models put forward by Heckscher-Ohlin (1933); MacDougall (1960) and Kemp (1964), referred to as the MacDougall-Kemp model. According to this model, FDI tends to flow in a location where it obtains more profitability because of lower production cost and exchange rate risks. In the early period, the capital-market approach and theory of portfolio flows was used to describe the initiation of FDI. According to these theories, the important reason for capital flows is interest rate differentials. This approach states that when there are no uncertainties or no risks, capital tends to flow within the region where capital gets highest return. However, this approach fails to incorporate the fundamental difference between portfolio and direct investment.
2.2.2 Industrial Organization Approach

Stephen Hymer was one of the pioneering economists to establish systematic approach towards the study of FDI theories. Hymer in his doctoral dissertation (1960) developed the industrial organization approach of FDI theories and first explained the concept of ownership advantage. His theory of FDI was the very first work which explains international production, firm-specific advantage and activities of the Multinational enterprises (MNC). His theory was highly favored by Lemfalussy (1961), Kindleberger (1969), Knickerboker (1973), Caves (1974), Dunning (1974), Vaitsos (1974) Cohen (1975).

Hymer argued that the imperfection in the market leads to the existence of MNCs. His theory focused on two types imperfections in the market. These imperfections are first, the imperfections in transaction-cost and second imperfections in the size of the organization. According to Hymer the bigger size of the firm brings the ownership advantages to the foreign firm in order to compete with domestic firms. The industrial organization approach explains that an MNC faces a number of disadvantages in investing in the foreign nation. These disadvantages are in the form of legal complications, cultural differences and language differences etc. However, in spite of these differences an MNC enjoys some firm-specific advantages over the domestic firm. These advantages include superior technology, brand name, managerial skills and economies of scale. Sodersten (1970) also argues that willingness to increase profits by taking the advantage of some technological superiority or superior organizational form are the main causes of direct investment. The rate of return motivates the movement of capital and capital moves from countries with low marginal productivity to the countries with high marginal productivity and thus their activities equalize the marginal productivities throughout the world. (Viner, 1951). This explanation transforms FDI from neoclassical trade theories into industrial organization theory. But this approach fails to explain the actual reasons of MNC’s decision to go international in the form of FDI. The eclectic approach by Dunning in 1977, 1979 and 1988 and internalization theory by Buckley and Casson in 1976 further explain the industrial organization approach to FDI theories.
2.2.3 Product Life Cycle Theory

Competition between firms affects their decision to cut production costs to become more competitive which directed Raymond Vernon (1966) to explore the theory of product life cycle. He used the US multinational data to explain the cycle of their expansion and found that firms choose to invest directly in a given place as an alternative to exporting. This theory assumes that most products follow a life cycle in which they first appear as innovations and ultimately become completely standardized. The theory attempts to integrate three stages of production to explain the life cycle of a product. In the first stage of the introduction of the product, the stage is called as ‘innovation’. At this stage the producers are mainly concerned with the degree of freedom of their product and they invest highly on the research and development of the product. At this stage the product is designed, developed and produced domestically in limited number. After the establishment of the product in the home market, the foreign demand is generally met by undertaking export in the initial phase.

In the second stage the product gets ‘mature’. At this stage, the price elasticity of demand for the product is comparatively low. The demand for the product rises in the foreign market and competitors emerge. The producer establishes its production unit in the foreign country to cater to the increased foreign demand and to compete with the rivals. Thus, in the second stage the firm becomes international. The final stage is characterized by product standardization. The production technique becomes well known and reaches to the acme. Engineers make no changes in product design. Investment is moved further to lower cost and lower wage countries. The product is exported to the original country of innovation where the product is phased out in order to favor innovation of new product. Thus the exporter becomes importer in this stage of production.

2.2.4 Monopolistic Power

Kindelberger (1969) in his remarkable work ‘American Business Abroad’ put forward his theory of FDI on monopolistic power extending the works of Hymer (1960). Kindelberger argued that advantages enjoyed by a Multinational firm can be useful only
in the case of market imperfection. The advantages described by him may be in the form of superior technology, managerial expertise, patents etc. These advantages generally encourage a firm to invest in a foreign country. A firm normally prefers to fully exploit these advantages instead of sharing them with potential competitors in the foreign market. Higher the chance of earning monopoly profits, higher is the encouragement among the firms to invest directly. Thus, the monopolistic advantages and economies of scale enjoyed by foreign firms over the host country firms are the major determinants of international investment by MNCs. The zeal among the international retail firms like Walmart to invest in India reflects the proposition of the monopolistic power theory of Kindleberger.

2.2.5 Internalization Theory

Buckley and Casson (1976) came out with argument that foreign direct investment is the result of the firm’s intermediate products, notable knowledge which helps them to internalize their product. This is a complementary work to Coase (1937) where he argued that firm’s internal practice with transaction costs is better suited than the market to organize transactions. Following Hymer (1960) the authors also maintained the assumption of market imperfection and firm specific advantages for a firm to become international. This theory differs from Hymer with the assumption that firms do not need monopolistic or oligopolistic power at the beginning. However, it acknowledges later that monopolistic or oligopolistic advantages could also be internalized (Casson, 1986; Teece, 1981) or internalization of intermediate products could lead to monopolistic or oligopolistic advantages (Casson, 1987). When there is high level of imperfections in the market, it would be more efficient for a firm to go international and internalize these advantages.

Buckley and Casson identified five different types of market imperfections that result into internalization. First, at the time when the co-ordination of resources for a long period is required, second, when the efficient exploitation of market power requires discriminatory pricing, third, when bilateral monopoly produces unstable bargaining situations, fourth,
when the buyer cannot correctly estimate the price of the goods on sale, finally, when government interventions in international markets create incentives for transfer pricing.

### 2.2.6 Eclectic Paradigm/ OLI Paradigm

John Dunning (1977, 1979 and 1988) in his path breaking works amalgamated three different explanations why a firm opens its foreign subsidiary. The theory also discussed the entry choice for MNCs. This theory of eclectic paradigm is also referred to as OLI paradigm. In his theory Dunning integrated the oligopolistic theory or the theory of Industrial organization, the internalization theory and location theory to explain the reasons for firms to operate internationally. Dunning argued that the Ownership advantages (O), Locational Advantages (L) and Internalization (I) are the preconditions for a firm to produce its goods internationally. Ownership advantages referred to the MNE’s production process, ensuring a competitive advantage over domestic firms and include patents, technical knowledge, management skills and reputation. According to ownership advantage if firm wants to undertake foreign investment, it should have some types of owning assets to conquer the shortcomings of operating in a foreign economy. These advantages may be in the form of both tangible and intangible assets. They may be in the form of natural endowments, superior technology, brand name, managerial and marketing skills and scale economies. This ownership advantage leads to reduction of firm’s production cost and allow it to compete with domestic firms in the foreign economy.

Location advantages of different countries play a significant role in determining host countries for the activities of the multinational corporations. Location advantages may be in the form of access to protected markets, favorable tax treatments, lower production and transport costs, and cheap inputs for production, lower risk, jumping trade barriers, legislation and policies, and the political, legal, and cultural environments etc. (Dunning and Lundan, 2008)
When the above two conditions are fulfilled internalization occurred to the firm. Market imperfections can be decrease by internalizing operations, allowing a decline in transaction costs related with risks of copying technology (Dunning, 2002). The cross-border market internalization helps the firm to make higher profits then offering this right under license, franchise etc. The exploitation of these advantages relies mainly on the relative cost of equity and non-equity forms of managing interrelated economic activities.

In eclectic approach, Dunning explained that all foreign investment can be explained with reference to the above conditions. He also explained that the advantages mentioned above are not likely to be uniformly spread among all the countries, industries, and enterprises and are also likely to change over time. The flows of foreign direct investment of a particular country at a particular point in time depend on the ownership and internalization advantages of the country’s firms and on the location advantages of the country at that point of time.

2.2.7 Oligopolistic Theory

Knickerbocker (1973) argues that in oligopolistic market conditions, when a firm makes a foreign investment, it will encourage other potential competitors in the same industry to invest in the same foreign market so as to sustain their market share. Firms tend to follow competitors in their internationalization decisions; this behavior is also found in the case of domestic diversification (Lamfalussy, 1961). The theory integrates various theories of investment like location, monopolistic competition, exchange rate to give comprehensive view on oligopolistic market structure theory of FDI. Knickerbocker used large number of US MNC data and calculated an entry concentration index to show the extent to which subsidiaries’ entry dates were clustered in time. The index finds a positive correlation between following the rivals in international investment and big market size.

The essence of the oligopolistic theory is that firms operating abroad and over long distance suffer from an intrinsic disadvantage due to the differences in the language, lack of knowledge of local laws and market conditions. These disadvantages must be overcome by some sort of market power to make the international investment profitable.
(Nayak, 1999). However, the theory was criticized on the grounds that these disadvantages of the foreign market can be averted well by exporting or licensing instead of making direct investment.

### 2.2.8 Strength of Currency

Aliber (1970) presented his theory of foreign investment on the basis of the relative strength of the various currencies. He identified some of the unique characteristics of international investment which were not available in the domestic investment. He explained his theory in terms of the differences in the strength of the currencies in the host and source country. He postulated that weaker currencies compared to stronger investing country currencies have higher capacity to attract FDI. Firms from the stronger currency countries will invest in the weaker currency countries in order to take the advantages of differences applied in the market capitalization rate. Aliber has tested his hypothesis in the USA, UK and Canada.

Even though Aliber claims it to be an alternative theory, the fundamental assumption of the theory lies in some kind of biasness in the capital market. The imperfect market forces help the investors to increase their profits. Some of the notable studies in the same arena are Caves (1988), Froot & Stein (1991) and De Mello (1997).

### 2.2.9 FDI theories related to International trade (A New theory of Trade)

Recently, explanation of FDI combines the OLI framework with technology and the intrinsic characteristics of a country in the form of factor endowments which is known as a “new theory of trade which is based on Kindleberger’s theoretical models (1969) along with those of Hymer (1976) and Caves (1971). This theoretical explanation has been empirically tested by several empirical studies (e.g., Helpman, 1984, 1985; Markusen, 1984, 2002). According to a new theory of trade, the expansion of FDI in the last two decades and continuous growth in the output of the MNCs has changed the structure of the international trade to a large extent. Hence a number of attempts have been made to integrate FDI theory with theory of international trade. Dependence on traditional export,
licensing etc. has got eroded with the changes in way of conducting business. Since 1970s, a steady growth has been noticed in the overseas shipments by MNCs to its subsidiary. A significant amount of international trade flows no longer takes place, as the foreign demands are met by overseas production of MNCs as against exporting them from original country of production (Cohen, 2007). Graham (1996) says foreign direct investment has by some measures become even more important than international trade. UNCTAD (2004) estimated that one third of the total international trade occurs between the intra firms.

Even though Adam Smith was the pioneer of the international trade theories, many theories were put forward by the economist like Ricardo, Haberler, Hechscher –Ohlin, Krugman etc. However, all the theories maintain that a country will produce and export that good which it can produce at relatively lower cost and will import the good which it produces at a relatively higher cost.

Hirsch (1976) developed his theory of international trade and investment to find the answer of two important questions. First, when does the profit- maximizing firm choose to serve foreign market and the conditions which lead to its foreign investment and export. In the absence of transport and marketing costs, optimum size plants will be less costly to operate in countries enjoying comparative advantage. Economies of scale are not associated with the size of the domestic market; thus they enhance rather than counteract comparative advantage. International direct investment takes place only in a world which admits revenue-producing factors which are firm specific on the one hand and information, communication, and transaction costs, which increase with economic distance, on the other.

Kojima (1978) was the first economist who tried to integrate trade theories and international investment theories. He explained trade and investment by a common theory. Kojima strongly recommended that FDI is required in order to make factor markets more competitive and efficient internationally and to improve production processes in the country which is well endowed with the given resource. He believed that MNEs would lead to the improvement of production and exports of host economy if it
transfers a package of capital, managerial skills and technology from an industry which has a comparative disadvantage in the investing country compared to the recipient country. This process contributes to increase productivity and comparative advantage of host country. (Kusluvan, 1998) A firm would like to make international investment only when it expects to earn higher profit from there by using its advantages over the foreign firm which are not available with its competitors.

Kojima identified resource oriented, labor oriented and market oriented as the three major motives behind the international investment of a firm. If a firm invests with a view to increasing and securing the imports of the goods which home country lacks or produces at a higher cost, it is referred to as trade oriented or resource oriented FDI in Kojima’s term. If investment is made to reap the benefit of cheaper labor cost it is known as labor oriented FDI. Investments made in order to capture a big market or to supersede the trade barriers is called as market oriented FDI.

Helpman (1984) developed a general equilibrium model which deals with the firms producing single product. This is an extension of his own work (Helpman, 1983a, 1983b). His model is based on the differences in the factor endowments in different locations where a vertical MNC chooses to start its production centre. The model argues that firms like to choose cost minimizing locations to maximize their profits. The differences in the factor endowments are associated with relative size of the country. The theory identifies and analyzes the circumstances in which corporations find it profitable to become multinational. The theory explains the simultaneous existence of inter-sectoral trade, intra-industry trade, and intra-firm trade. The theory also explains cross-country penetration of multinational corporations as a result of impediments to trade.

Markusen and Venables (2000) argue that the decision of the firm whether to export or to produce in the foreign market depends on the Proximity concentration tradeoffs. Firms compare the cost of producing the goods domestically and export it (export cost) with the cost of producing the good in different locations. When a firm produces goods in a single location in a large scale it gets the advantage of economies of scale, and in contrast to that
it can get the better market access if it produces the goods in the market where it is demanded.

The theory finds that the multinationals tend to reach their equilibrium point when firm-level economies of scale and tariff or transport costs are large compared to the plant-level economics of scale. Multinationals become more important relative to trade as countries become more similar in size, relative endowments, and as world income grows. The new trade theory concentrates on competition between national firms of similar countries.

Brainard (1993) developed a two sector and two country model, which describe that firms producing differentiated products choose between exporting and expansion of international investment for catering to the demands in foreign market. The theory reveals that in corporate level producing, the cost of transport is lower than that of producing in plant level, while it is reverse in case of economic of scale. The model suggests that the restrictions on foreign investment will be more damaging to the welfare of the state than to restrict the trade of industries.

2.2.10 Summary of theories of FDI determinants

From the preceding discussions, it is, thus, evident that there is a large range of theories on FDI which find out a number of determinants that could explain FDI inflow into particular location. The major objectives of these studies are to provide the explanation of the reasons for a firm's decision to move internationally. However, there is no general theory of FDI, which covers all these motivations in a single theory as individual MNC has large number of strategic motivations behind undertaking FDI decisions. Since this study aims to identify the factors that have been found to best explain FDI inflow in emerging markets, this study concentrates on macro dimension. Table (2.1) summarizes the important theories of FDI determinants:
Table 2.1: Review of theoretical approach of FDI determinants

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<tr>
<th>Theory/Theoretical approach</th>
<th>Determinants</th>
<th>Author(s) (year)</th>
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<tbody>
<tr>
<td>Heckscher-Ohlin Model / MacDougall-Kemp Model</td>
<td>Higher return on investment, lower labour costs, exchange risk</td>
<td>Heckscher and Ohlin (1933), Hobson (1914), Jasay (1960), MacDougall (1960), Kemp (1964), Aliber (1970)</td>
</tr>
<tr>
<td>Market imperfections</td>
<td>Ownership benefits (product differentiation), economies of scale, government incentives</td>
<td>Hymer (1976), Kindleberger (1969)</td>
</tr>
<tr>
<td>Industrial organisation approach</td>
<td>Imperfect competition</td>
<td>Buckley and Casson (1976)</td>
</tr>
<tr>
<td>Oligopoly markets</td>
<td>Following rivals, responding to competition in domestic market</td>
<td>Knickerbocker (1973)</td>
</tr>
<tr>
<td>Product life cycle</td>
<td>Production function characteristics</td>
<td>Vernon (1966)</td>
</tr>
<tr>
<td>Behaviour theory</td>
<td>Fear of loss of competitive edge, following rivals and increased competition at home</td>
<td>Aharoni (1966)</td>
</tr>
<tr>
<td>Internalisation</td>
<td>Market failures/inefficiencies</td>
<td>Buckley and Casson (1976)</td>
</tr>
<tr>
<td>Eclectic paradigm (OLI - Ownership, location, internalisation)</td>
<td>Benefit of owning productive processes, patents, technology, management skills</td>
<td>Dunning (1977, 1979, 1988)</td>
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The above table (2.1) illustrates the summary of important theoretical approaches of FDI determinants. Using major theoretical approaches given above several empirical studies

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<tr>
<td>Factor endowments</td>
<td>Financial and economic incentives</td>
<td>Source: Assuncao et.al (2011)</td>
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<tr>
<td>Political variables approach</td>
<td>Tariffs</td>
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<td>Tax rate</td>
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identify important factors which impact on FDI inflow into particular location. Some of the important factors explained by various research studies are as follows:

### 2.3 Empirical Literature on Determinants of FDI

On the basis of theoretical explanations which have been listed in the above table, several empirical studies have been carried out in order to evaluate the key determinants of FDI inflow into particular location. These empirical studies are mostly connected with OLI framework, institutional approach, and to the new theory of trade and FDI. Major factors/Determinants of FDI which influence the FDI inflows as empirically investigated by different research studies are listed below:

1. Market Size & Market Growth (New theory of Trade)
2. Openness of the country (New theory of Trade)
3. Production cost/ Factor endowments (New theory of Trade)
4. Infrastructure (OLI Paradigm)
5. Human Capital (OLI Paradigm)
6. Economic stability (OLI Paradigm)
7. Institutional approach
   - 7.1. Corruption
8. Factor endowments
9. Exchange Rate

#### 2.3.1 Market Size & Market Growth

Market size is widely accepted important determinant of FDI flows into particular location. Higher market size indicates larger potential demand, higher purchasing power and low cost due to economies of scale where firms can potentially receive higher returns on investment on their capital. (Bhavan et al., 2011; Shahmoradi, 2010; Walsh and Yu, 2010; Leitao and Faustino, 2010; Leitao, 2010; Lv et al., 2010; Hailu, 2010; Schneier and Matei, 2010; Mohamed and Sidiropoulos, 2010).
Generally it is expected that there is positive relationship between Market Size and FDI (Vijayakumar et al., 2010), whereas a few studies did not obtain any conclusive results for this determinant of FDI. Using number of inhabitants for market size, Mohamed and Sidiropoulos (2010) did not get decisive results. Using the same proxy, Botrić and Škuflić (2006) found a significant negative effect, as the sample size of countries was small. Applying Market growth as a determinant of FDI most of the studies (Schneider and Frey, 1985; Cleeve, 2008; Mohamed and Sidiropoulos, 2010) found a positive relation, whereas Mhlanga et al. (2010) and Vijayakumar et al. (2010) got inconclusive results (Assuncao, 2011). A number of studies used Gross Domestic Product (GDP), GDP growth rate, per capita GDP or gross national product (GNP) for the market size of a country or income within the country. Some of the studies used one-period lagged form of these variables to avoid non-stationary of data.

### 2.3.2 Openness of the country

Countries are able to receive higher level of FDI inflows if they implemented reforms that liberalize their economies; hence it is generally believed that more open economy attracts more FDI. (Asiedu, 2006; Vijayakumar et al., 2010; Choong and Lam, 2010). Most of the studies have taken trade openness for measuring openness of the country. The majority of the studies on determinants of FDI found that trade openness is positively related to FDI in host country but the impact of openness on FDI depends on whether the investment is market seeking or export-oriented. The positive relationship between FDI and trade volumes implies that countries that wish to attract more FDI should increase trade. Export-oriented MNCs prefer to locate to a more open economy because trade protection generally states higher transaction cost associated with exporting. On the other hand, according to ‘tariff jumping’ hypothesis less open economy with trade restrictions can have a positive effect on FDI (Market-Seeking). A decrease in openness might be associated with more horizontal FDI, as investing firms might benefit from circumventing trade barriers through building production sites abroad and increase in the trade openness increases more vertical FDI (Reshmini, 2000; Walsh & Yu, 2010).
Most of the FDI literature used share of trade in GDP as a proxy of trade openness (Bhavan et al., 2011; Ting and Tang, 2010; Leitao and Faustino, 2010; Leitao, 2010). According to Asiedu (2006) countries that want to attract more FDI inflow ought to increase international trade also.

2.3.3 Production Cost

It is expected that lower production costs leads more FDI into particular location. Most of the studies measured lower production cost by wage rate into the host economy considering labor as the important factor of production. A higher wage corresponds to a lower level of FDI as higher wage reflects more production cost. Dependency hypothesis and modernization hypothesis agreed with the importance of low-cost labor in attracting FDI (International Division of labor). Goldsrogh (1997), Saunders (1982), Flamm (1984), Schneider and Frey (1985), Culem (1988), Shamsuddin (1994) explains that higher wages discourage FDI. Tsai (1994) obtains strong support for cheap-labor hypothesis for the period 1983-1986 but weak support from 1975 to 1978.

2.3.4 Infrastructure

It is observed that the countries with better infrastructure have greater FDI inflows as compared to those lacking necessary infrastructure facilities. A number of studies (Wheeler and Mody, 1992; Chen, 1996; Noorbakhsh et.al, 2001; Kumar, 2002; Banga, 2003; Moosa and Cardak, 2006; Quazi, 2007; Rozas and Vadlamannati, 2009 etc.) find infrastructure as an important determinant of FDI inflows. For example, Wheeler and Mody (1992), Loree and Guisinger (1995), Chen (1996), Mody and Srinivasan (1998), Kumar (2002) and Abdul (2007) find positive influence of quality physical infrastructure on FDI inflows. Similarly, Banga (2003), Majumdar (2005), Archana (2006), Moosa and Cardak (2006), Siddharthan (2008) and Rozas and Vadlamannati (2009) etc. find both physical and social infrastructure as important determinants of inter-state variations in FDI inflows. As regards social infrastructure, while education is found to have significant influence on FDI inflows (Hanson, 1996; Noorbakhsh et.al, 2001; Archana, 2006), the
role of health infrastructure is not adequately explored except in a few studies like Globerman & Shapiro (2002) and Chakravorty (2003).

However, there are also studies that find only weak relationship between FDI inflows and infrastructure. For instance, Chakravorty (2003) finds little significance of infrastructure in determining the location or quantity of new industrial investment, whereas Kirkpatrick et al. (2006) and Pradhan (2008) find negative impact of the same on FDI inflows. Besides, Nunnenkamp and Stracke (2007) do not find any significant influence of electricity and education on FDI inflows across Indian states. Similarly, Root and Ahmed (1978), Lheem and Guo (2004), Quazi (2007) do not find human capital as a significant determinant of FDI.

2.3.5 Policy Variables

FDI flows are likely to be encouraged by government policies that lead to the establishment of a legal-institutional framework that is conducive to business activity. FDI is likely to be attracted to countries where governments ensure an adequate provision of economic and social infrastructure in the form of paved roads, ports, airfields, relatively cheap energy supplies, and a well-educated and disciplined work force. According to UNCTAD survey Tax policy, Trade Policy, Privatization Policy, Macroeconomic Policy are the important policy variables which affect FDI (UNCTAD 2006).

In less developed countries the majority of entrepreneurs constantly fear policy, surprises unexpected changes in rules that can seriously affect their business. Entrepreneurs in Asia have the most trust in government announcements of policy changes and changes in rules (Institutional Obstacles to Doing Business, World Bank 1997). The inflation rate is used to measure the level of economic stability. High level of inflation rate means low level of economic stability. It is expected a negative sign (Naudé, and Krugell, 2007).
2.3.6 Institutional and Political factors

Business decisions by MNCs may largely be influenced by the institutional factors like governance, business environment, political structure, etc. Institutional and political factors which affect the business climate have a direct influence on FDI. Generally, it is believed that better governance in the host country attracts more FDI inflow. Literature on institutional determinants of FDI suggests that good economic institutions, effective Rule of Law, Government Effectiveness, Regulatory Quality, Control of Corruption, and intellectual property rights all attract more FDI inflow into the host country (Acemoglu and Simon, 2005; Kaufmann and Aart, 2002; Rodrik and Subramanian, 2003). In contrast, poor institutional environment in terms of corruption and weak enforcement of contracts imposes additional cost for the foreign investors and deters foreign investment in the host economy (Shleifer and Vishny, 1993; Wei, 2000). FDI has huge sunk costs and hence it is very difficult for foreign investors to make investment decisions. Foreign investors first ensure long-term contracts to reduce all types of uncertainty. Therefore, government stability and effective Rule of Law are especially important to attract higher FDI inflow in the host economy (Busse and Hefeker, 2007; Naude and Waldo, 2007). According to a World Bank study, time spent by managers dealing with bureaucracy to obtain licenses and permits has a detrimental effect on FDI inflow across 69 countries. This study assumed other factors such as human capital, market size, and macroeconomic stability as constant. (World Bank, 2003).

Although a number of the existing studies (Schneider and Frey, 1985; Edwards, 1990; Wheeler and Mody, 1992; Loree and Guisinger, 1995; Hanson, 1996; Jaspersen et al., 2000; Globerman and Shapiro, 2002; Banga, 2003; Kirkpatrick et. al., 2006; Abdul, 2007; Dumlu dag, 2009) attempt to explain FDI inflows in terms of institutional factors, the nature of relationship is not very clear. For example, Schneider and Frey (1985) and Edwards (1990) find that political instability reduces FDI inflows. On the other hand, Loree and Guisinger (1995), Hanson (1996) and Jaspersen et. al. (2000) do not find any significant relationship between political instability and FDI inflows. Similarly, Abdul (2007) does not find any significant impact of corruption on FDI inflows. Further, the existing studies are mostly country specific and, therefore, influence of institutions on
FDI inflows at the sector level has remained largely unexplored, especially in the context of emerging markets.

Some of the recent studies examined the role of institutional and political factors on capital flows from the developing to developing countries, known as South–South FDI. According to Aleksynska and Havrylchyk (2011), when MNCs from the emerging/developing countries invest in countries with superior institutions, the institutional distance can be viewed as a motivating force as most of the emerging countries obtain new technologies, patents, IPRs, trademarks, and brands. MNCs believed that these ownership-specific advantages will be protected in good institutional environments. They also found that FDI inflow is discouraged when emerging countries invest in countries with worse/incompetent institutions. The main reason behind this weak effect is that investors or MNCs, having previous experience with weak or incompetent institutions, may have a comparative advantage in investing in other emerging or developing economies which suffer from the weak institutions like ineffective Rule of Law, corruption, and political instability. To take advantage of the previous experience with corrupt environments, investors from countries with a high prevalence of corruption and lack of enforcement of anticorruption laws internalize their production with countries that have similarly corrupt environments (Cuervo-Cazurra, 2006). Habib and Zurawicki (2002) and Benjamin-Quere et al. (2007) used the concept of psychic distance, which states that MNCs tend to enter a market where they found psychological closeness. Accordingly, they found that the larger institutional distance decreases FDI flows between the countries. Claessens and Van Hor (2008) found that FDI flow in the banking industry is affected adversely by large distances among institutions. According to Darby et.al (2009), MNCs which have very little experience of imperfect institutions in the home economy are discouraged by institutional deficiencies abroad. These studies suggest that different investors have different motivations to invest in particular locations. Weak institutions do not always deter the FDI inflow in a host country; it therefore is not always necessary for these countries to improve their quality of institutions in order to attract foreign investment.
Empirical studies also demonstrate that FDI inflows between emerging to emerging market known as the South–South FDI is driven by natural resources. (Aleksynska and Havrylchyk, 2011). Countries that are endowed with natural resource availability have a very poor quality of institution; still, there is significant FDI inflow into these countries. Most African countries have poor institutions, but recently much FDI from China has been flowing to these countries to take advantage of their natural resources. Asiedu (2006) found that large market size, natural resource endowment, macroeconomic stability, an efficient legal system, and a good investment framework promote FDI in African countries. Specific institutional determinants of FDI inflow may of course be different for different economies. According to Duanmu and Guey (2009), FDI outflow from China and India show important dissimilarities. Chinese encourage FDI by open economic regimes, depreciated host currency, and a better institutional environment, but these factors are not important for Indian FDI outflow in other countries. Mohamed and Sidiropoulos (2010) concluded that the key determinants of FDI inflows in MENA countries are the size of the host economy, the government size, natural resources, and institutional variables.

2.3.7 Corruption

There exists mixed evidence in the literature with respect to relationship between the level of corruption and FDI inflow. Corruption has a negative impact on the level of investment. Corruption raises the cost of investment, decreases the expected profitability and hence acts as tax for investors because corruption in the investing economy needs to pay extra costs in the form of bribes in order to obtain various government permits and licenses. (Al-Sadig, 2009; Bardhan 1997). Therefore, MNCs / foreign investor have a tendency to avoid investing in countries with high levels of corruption.

According to Javorick and Wei (2009) corruption impacts negatively on inward FDI and it shift ownership structure towards joint ventures in emerging markets. This study uses unique firm-level data set. According to this paper, corruption acts as a tax to the foreign investors as it makes local bureaucracy less transparent. To reduce the bureaucratic maze, foreign investors choose joining hand with domestic partners on one hand and on the
other hand it reduces the value of having a local partner as corruption decreases reliance between foreign and domestic partners with respect to effective rule of law which will protect the investor’s intangible assets and lowers the probability that disputes will be arbitrated fairly.

According to Habib and Zurawicki (2002) corruption generates negative impact on foreign direct investment (FDI) inflow into 89 countries which includes developed, developing, and the transition economies. In this paper two ways impact of corruption has been examined which includes the level of corruption in the host country and the absolute difference in the corruption level between the host and home country. Results provide support for the negative impacts of both and MNCs generally avoid corruption as it is considered immoral and it can generate operational inefficiencies.

Al-Sadig (2009) empirically tested that FDI inflows are affected adversely by the corruption level in the host country. Results of this study state that after controlling for other characteristics of the host country such as the quality of institutions, the negative effects of corruption disappear and sometimes it becomes positive but statistically insignificant. In fact, the results show that the country’s quality of institutions is more important than the level of corruption in encouraging FDI inflows into the country. For instance, ceteris paribus, a country with sound institutions is able to attract as much as 29 percent more per capita FDI inflows than a country with poor institutions. Incomplete information with respect to actual type of a host government being honest or corrupt could discourage FDI where the probability of the host government being corrupt is sufficiently high.

According to Wei (2000) increase in corruption level and tax in the host country decrease inward FDI. This study empirically proves taking into consideration of 14 source countries to 45 host countries. This study examines the effect of corruption on the firm-level investments decisions and growth. Overall result suggest that corruption plays a relative vital role in investment growth compared to other variables like market size, firm Size, trade orientations, openness to trade etc. Corruption generates negative impact for
transitions countries but has no significant effect for Latin American, Sub-Saharan and Caribbean countries.

Empirical analyses with respect to relationship between FDI and Corruption has not always confirmed the negative relationship between corruption and FDI (Habib and Zurawicki, 2002). There are some empirical studies which state that there is non-significant relationship between FDI and its impact on corruption (Hines, 1995; Wheeler and Mody, 1992).

2.3.8 Natural Resources

Resource-seeking FDI is motivated by the availability of natural resources in host countries. This type of FDI was historically fairly important and remains a relevant source of FDI for various developing countries. Natural resources play vital role in overall FDI attraction or decision. Several studies (Aseidu, 2005, 2006; Dupasquier and Osajwe, 2006) show that natural resources in African countries attract more FDI. Deichmann et al., 2003 explains that in transition economies of Euro-Asia countries natural resources play important role as determining factor.

2.3.9 Exchange Rate

It is generally identified that a weaker real exchange rate might be expected to increase vertical FDI as depreciation makes host country assets less expensive relative to assets in the home country (Walsh and Yu, 2010). Froot and Stein (1991) found that a weaker host country currency tends to increase inward FDI within an imperfect capital market model as depreciation makes host country assets less expensive relative to assets in the home country. Blonigen (1997) makes a “firm-specific asset” argument to show that exchange rate depreciation in host countries tends to increase FDI inflows. A stronger real exchange rate might be expected to strengthen the incentive of foreign companies to produce domestically: the exchange rate is in a sense a barrier to entry in the market that could lead to more horizontal FDI.
2.4 Empirical Studies with respect to EMEs

According to Masron and Abdullah (2010) Institutional quality is crucial as a part of future policy strategy to further attract new FDI to inflows into the ASEAN countries. This study studied the impact of various institutional variables like Voice and accountability, Political stability and absence of violence, Government effectiveness, Regulatory quality, Rule of law, Control of corruption variables from World Development Indicators and has drawn conclusion from these indicators.

Bhavan et.al (2011) found that distance, home and host country characteristics, trade openness index, human development index, population and infrastructure are found to have significant factors motivating FDI inflow in India (South Asian countries). Azam (2010) found that there is a positive linkage between exports, foreign direct investment and economic growth. Size of domestic market, attractiveness of domestic market, and technology growth are statistically significant in determining FDI in India.

2.5 Gaps in existing literature

From the preceding discussions, it is, thus, evident that a large number of empirical studies have analyzed the determinants of FDI, but the results on empirical evidences are mixed and inconclusive on this issue. Such differences in findings may be contributed to the differences in types of data used, choice of country, time-periods, selection of independent variables, data selection and applied methodology etc. For example several studies (Nunnekamp and Stracke, 2007; Noorbakhsh, et.al. 2001) have used data on proposed/ approved FDI and not data on actual inflows. As there is a substantial gap between the proposed/ approved amount and actual investment inflows, the conclusions are likely to differ. Large Number of studies do not find any statistically significant relation for some determinants (e.g. infrastructure, institutional quality, financial and fiscal incentives, market growth, and openness of the economy). There is lack of research on institutional related variables which have impact on sectoral FDI inflows in emerging economies (Mehic, Brkic, & Selimovie, 2009).
As sector-specific dynamics vary, macroeconomic factors are expected to create varying impacts. Therefore, it is vital to identify sector specific determinants of FDI, which hardly exist in the context of emerging markets due to lack of availability of sectoral data. Most of the studies have broadly taken country-level, industry-level, and firm-level data to analyze determinants of the FDI, but these studies do not explain much of the fact why FDI is not equally distributed among the different sectors at the same time. There is a difference between sector and country specific determinants of FDI, therefore it is important to understand the sectoral level determinants of FDI for attracting FDI in particular sector.

Most of the studies focus on very specific regions and countries, such as Sub-Saharan Africa (Asiedu, 2006), MENA countries (Mohamed and Sidiropoulos, 2010), China (Cheung and Qian, 2009), India (Kumar and Chadha, 2009), Eurasia (Deichmann et al. 2003), the SADC (Mhlanga et al., 2010), Ex-Soviet Union (Ledyæva, 2009), BRICS (Vijaykumar et al., 2010). Only few studies cover a wider range of countries. (Assuncao, 2011)

Earlier studies have made use of cross sectional or time series analyses, which may have their inherent limitations, while analyses based on panel data model are very few.

2.6 Objectives

The present study attempts to fill these gaps. Accordingly, the objectives of the study are:

- To analyze trends in the growth of FDI inflow in emerging economies;
- To identify the country-specific and sector-specific determinants of FDI &
- To examine the role of county-specific and sector-specific determinants in influencing FDI inflow to the emerging economies.

The next chapter discussed the concepts, database and methodology to analyze the above objective followed by the trends and determinants of the FDI at country level and sector level.