# Critical evaluation of institutional factors impact on outward inward

ASSIGN BUSTER

Essay Critical Evaluation of Institutional Factors Impact on Outward/Inward Foreign Direct Investment This aim of this essay is to evaluate the impact of institutional factors on outward and inward FDI. This will be done by determination of the major FDI (Foreign Direct Investment) factors, evaluation of the role of institutional factors and investigation of institutional factors impact on inward and outward FDI flows.

Several sources (Aswathappa, 2012; Jensen, 2012) have identified FDI as an investment, made by a company based in one country (home country) into another company, which is based in other country (host country), in order to obtain certain degree of management control over that company. Recent evidence (Ho and Rashid, 2011) has demonstrated that a tendency for a firm to engage in foreign investment depends on a combination of different factors and elements.

Dunning (2011) has argued that company has to satisfy three conditions in order to successfully engage in international activity, which are ownership (know-how, technologies), localisation (natural resources, low production costs) and internationalisation. This theory is quite unique because it is developed by several important FDI determinants such as natural resources, production efficiency, strategic assets and market size. Nachum (1999) has argued that in accordance with Hymer's firm's specific advantages theory, companies are engaging in FDI if they possess specific advantages e. . access to raw materials, economy of scale, marketing advantages, etc. Aswathappa (2010) has suggested another FDI determinant which is ' follow the client/rival'. If one of the clients builds a foreign facility, it is reasonably for the company to follow the client and also build a foreign facility in order

to continue cooperating with the client. If one company goes to the foreign market it draws the attention of other similar companies, that can potentially exploit similar opportunity and therefore followthe rival.

The same source has also stated that market size is another crucial FDI determinant, which play important role for foreign investors. Nevertheless, Seyoum (2011) has argued that FDI inflows cannot be only determined by such variables as qualitative and skilled labour, availability of natural resources, technologies or modern infrastructure. It is essential to highlight the importance of role of institutional factors in attracting foreign investors. It was suggested by Solomon (2007) that foreign investors are seeking for countries with stable political and social institutions.

As it was figured out by Benassy-Quere, et al. (2007) the main institutional factors are: efficient protection of civil and property rights, economic and politic freedom and stability and corruption. Moreover, Globerman and Shapiro (2003) have stated that good institutions (well developed financial system, private property protection, government services, etc. ) have positive impact on both inward and outward FDI. Nevertheless, in some cases quality of institutions depends on FDI for instance, Chinese MNE’s value natural resources more than sound legal system or political stability (Kolstag and Wiig, 2012).

According to Jensen (2012) host country’s political regime is one of the most important determinants of FDI. It is considered that authoritarian regime is rather more stable than democratic. The same source has assumed that democracy may be influenced by the interests of the particular groups, which can increase tax rates, trade barriers or implement protectionism

policies in order to protect domestic companies from foreign MNE’s. A study carried out by (Knutsen, et al. , 2011) has stated that authoritarian regimes can reduce labour costs supressing human or different organisation rights e. g. hild labour and trade unions and therefore decrease costs for foreign investors. Nonetheless, there is counterargument provided by the same sources (Jensen, 2012; Knutsen, et al. 2011) which suggests that democracy has rather more positive effects on FDI that authoritarian regime. It was argued that reducedchild labourcan increaseeducationlevel and trade unions can bring more social stability. In some cases MNE’s are able to influence democratic country’s government in their favour. Moreover, investments in non-democratic countries may hurt reputation of the foreign investors and decrease demand for their products at home market.

Recent evidence (Hatchondo and Martinez, 2011) has argued that foreign investors enjoy sound legal protection system. Another source (OECD, 2008) has suggested that higher protection standards results in the greater positive impact on FDI. It was also argued that governments with free market economy have more efficient legal protection system than countries where economy is heavily influenced by government e. g. China. Free market economy is based on ownership, therefore MNE’s from such countries value property rights and they tend to select host countries with the same regulations and laws (Hsu, Zhang and Long, 2007).

Level of corruption, is quite contradicting aspect of inward FDI. It is mostly assumed to have negative impact on FDI. Firstly, it brings additional costs, if foreign investors have to bribe someone. Secondly, corruption involves more uncertainty and risk because it is done in illegal way. Furthermore bribed

contracts cannot be enforced in court. This issue is also able to impact on outward FDI, because investors tend to exclude possible risks and uncertainty (Wei, 2000; Knutsen, et al. , 2011). However, Egger and Winner (2005) have suggested that corruption may be beneficial for the FDI.

The authors have described an idea of “ grabbing hand” and “ helping hand”. It was said that, indeed, corruption bring additional costs and uncertainty for foreign investors and acts as the host country’s “ grabbing hand” but it is only in the short run. It was stated that in long run corruption might be attractive for foreign investors. Corruption allows speeding up bureaucratic procedures or can help to avoid regulatory and administrative restrictions and therefore it will act as the “ helping hand”. Ultimately, if the revenue effects are bigger that costs effects corruption is likely to be positive for FDI.

In accordance with several studies (Wells, 2001; Azemar and Delios, 2008) it was figured out that taxes have relatively small impact on IFDI (Inward Foreign Direct Investment). The authors have stated that in some cases foreign investors are much likely to focus on large market size with rather high tax rates than on country with small market size and much lower tax rates. Nevertheless, it was suggested that countries with excessive tax rates are much likely to kill IFDI however the countries with reasonable tax rates may exert little or almost no influence on IFDI.

Furthermore, it was also mentioned that tax havens demonstrate that countries (or regions) with extremely low tax rates are important determinant of the IFDI e. g. Delaware in the USA. Peng and Parente (2012) have stated that bureaucratic regulations and heavy taxation on domestic

earnings in Brazil have pushed two thirds of the OFDI stock to tax havens. Another interesting idea was proposed by Wells (2001) it was argued that if host countries policymakers have better understanding of how tax policies can affect the foreign investors, they would be more successful in terms of attracting FDI's.

For, example tax holiday policy could stimulate IFDI flows. A number of authors (Kolstag and Wiig, 2012; Kalotay and Sulstarova, 2010) have figured out that OFDI (Outward Foreign Direct Investment) may be heavily influenced by government or political changes. One of the best examples is Chinese " Open Door" and " Go Global" policies, it was argued that those changes has increased total Chinese OFDI from 3. 3% in 1996 to 10% in 2006 (Kolstag and Wiig, 2012). However, it was also described that most of the Chinese companies are state owned and their activities reflect political objectives e. . focus on natural resources. Political changes and stability is significant push factor. After the collapse of the Soviet Union, many Russian privately-owned companies were actively engaging in OFDI. The reason of that issue is that they tried to avoid uncertainty and find safeenvironmentwith stable political environment (Kalotay and Sulstarova, 2010). As it was figured out by several authors (Levent, 2006; Garcia and Navia, 2003) financial institutions are important ' Push' factor of OFDI. Financial conditions of the home country affect the decision to invest abroad.

If home country has poor financial system e. g. no access to financial support, unstable deposit base, high interest rates, etc. than the MNE's are much likely to seek countries with well-developed financial institutions. Another finding was proposed by (Kolstag and Wiig, 2012) arguing that in

some countries e. g. China, financial institutions are more cooperative with foreign investors that with the domestic companies, therefore companies are pushed to go overseas in order to obtain access to financial institutions.

Witt and Lewin (2007) have stated that misalignments between the firms needs and home country institutional conditions are pushing firms to go abroad. The authors have demonstrated that countries with relatively high societal coordination are slowly adapting changes in the extra-institutional environment and results as the misalignments between firms and home institutions. For example, in year 2003 Germany had high social contributions and taxes as well as others rigidities which have impacted on both OFDI and IFDI flows.

It was argued that every seventh German entrepreneur was planning to partly move abroad, every ninth was planning to move all production abroad and every thirteenth was thinking of relocating HQ (Head Quarter) abroad. Therefore, firms tend to seek the most appropriate for them institutional environment and if there is no such in home country, they are much likely to go abroad. Summarising all of the issues, it was figured out that most of the institutional factors have quite significant impact on IFDI and OFDI. The research has demonstrated that such nstitutional factors as political stability, governmental regime, corruption, legal system, financial institutions, etc. have serious impact on FDI. Nevertheless, there are some situations when other non-institutional factors may be more important, for instance China is focused more on the natural resources more than on the good institutions or market size might be more important for foreign investors than taxation

issues. It was also found out that some institutional determinants may have impact on both outward and inward FDI flows.

For example, political stability or corruption, these two factors may be applicable for both types of FDI flows. However, some of those institutional factors are better applicable for IFDI rather than OFDI or vice versa. References Aswathappa, K. (2010). ‘ Intrernational Business’, 4th Edition, pp. 100-112. New Dehli: McGraw Hill. Azemar, C. and Delious, A. (2008). ’ Tax competition and FDI: The special case of developing countries. Journal of the Japanese and International Economies’. 22 (1), pp. 85-108. Dunning, J (2011). New Challenges for International Business Research: Back TotThe Future, pp. 90-200. UK: Edward Elgar. Egger, P. and Winner, H. (2005). ‘ Evidence on corruption as an incentive for foreign direct investment’. European Journal of Political Economy. 21 (4), pp. 932-952. Garcia, A. and Navia, D. , (2003). ‘ DETERMINANTS AND IMPACT OF FINANCIAL SECTOR FDI TO EMERGING ECONOMIES: A HOME COUNTRY'S PERSPECTIVE’, pp. 21-23. Spain: Banco de Epa. Globerman, S. and D. Shapiro (2002). ‘ Global Foreign Direct Investment Flows: The Role of Governance Infrastructure’, World Development, 30, 11, 1899–919. Hatchondo, J. C. and Martinez, L. (2011). Legal Protection to Foreign Investors. Legal Protection to Foreign Investors’. 97 (2), pp. 175-187. Hsu, C. , Zhang, W. and Lok, L. , (2007). ‘ The Business and Investment Environment in Taiwan and Mainland China’, pp. 200-205. Singapore: World Scientific. Jensen, N. , (2012). ‘ Politics and Foreign Direct Investment’, pp. 8-14. USA: University of Michigan Press. Kalotay, K. and Sulstarova, A. (2010). ‘ Modelling Russian outward FDI’. Journal of

International Management. 16 (2), pp. 131-142. Kolstad, I. and Wiig, A. (2012). What determines Chinese outward FDI?.

Journal of World Business. 47 (1), pp. 26-34. Knutsen, C. H. , Rygh, A. and Hveem, H. (2011). ‘ Does State Ownership Matter? Institutions Effect on Foreign Direct Investment Revisited’. Business and Politics. 13 (1), pp. 1-31. Levent, I. (2006). ‘ Global DevelopmentFinance2006: The Development Potential of Surging Capital Flows’, pp. 107-110. Washington: WB Publications. Nachum, L. (1999). “ Home country and firm-specific ownership advantages: A study of US, UK and French advertising agencies”. International Business Review. 8 (5), pp. 633-660. OECD, (2008). Private Sector Development in the Middle East and North Africa Making Reforms Succeed’, pp. 124-126. France: OECD Publishing. Paul, J. (2008). ‘ International Business’, 4th Edition, pp. 235-240. New Dehli: PHI. Peng, M. and Parente, R. (2012). ‘ Institution-Based Weaknesses Behind Emerging Multinationals’. RAE. 52 (3), pp. 360-364. Quere, A. , Coupet, M. and Mayer, T. (2007). ‘ Institutional Determinants of Foreign Direct Investment’. The World Economy. 30 (5), pp. 764-782. Seyoum, B. (2011). ‘ Informal Institutions and Foreign Direct Investment’. Journal of Economic Issues. 45 (4), pp. 917-940. Solomon, B (2007).

Three Essays on the Impacts of Risk and Uncertainty on Foreign Direct Investment and Remittances Flows into Developing Countries, pp. 53-55. USA: ProQuest. Wei, S. -J. , (2000). ‘ How Taxing is Corruption on Internal Investors? ’, Review of Economics and Statistics, 82, 1, 1–11. Wells, L. (2001). ‘ Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs? ’ pp. 97-100. USA: WB Publications. Witt, M. and Lewin, A. ,

(2007). ‘ Outward foreign direct investment as escape response to home country institutional constraints’. Journal of International Business Studies. 38 (4), 579-594.