Conceptual framework for exploring FDI inflow to small economics: an institutional economics approach

Salah A. Alawadhi
Bradford Centre of International Business, Bradford (UK)
alawadhi@outlook.com

Abstract

This paper aims to provide a conceptual framework, as sophisticated tool to systematically assist MNCs when conducting examination of a host country as potential location, and as a guidance for any prospective host country to assess their position. The conceptual framework deploys both Transection Cost (TC) and Institutional Analysis and Development (IAD) as operationalize instrument to execute the theoretical underpinning fundamentals. The conceptual framework consists of four stages, which are organised in a progressive order, and at any stage, if MNCs find the result of their stage assessment unsatisfactory, the conceptual framework postulate that the MNC would then drop the location, which results in the host country losing the investment opportunity.

Keywords: FDI, Conceptual framework, Transection cost, Institution's analysis.

JEL classification: D04, F20, O2

Introduction

Foreign direct investment (FDI) is made when a business takes controlling ownership in a company, or entity in another country. Through FDI, foreign companies are directly involved with tasks in the hot country, resulting in a transfer of money, knowledge, skills, and technology. FDI has become an increasingly important channel for resource flows across national borders, it is strongly believed to have a major role to play in the economic development of developing countries. Most empirical studies conclude that FDI offers advantages to the foreign host country, such as: economic development, employment and economic boost, reduced costs, increased productivity, increase in a country's income (Luo, 2003; Nunnenkamp and Spatz, 2004; Giroud, 2007).

However, irrespective these substitutional benefits to the host country, a number of developing countries received lower FDI inflow than others, despite their competitiveness and advantages (UNCTAD, 2019), providing the rationale need for an assessment tool that can assess FDI inflow to a host country. Thus, the aim of this paper is to is to establish an assessment tool, conceptual framework, to better explain why some countries receive lower FDI inflow than others mainly targeting the developing countries in general and the small economics in particular, despite their competitiveness and advantages.

The best way to view the proposed assessment tool is to be looked at the context of conceptual framework that is used as a guide for an inquiry into a subject by constructing a category of intellectual scaffolding, which would then provide a coherent structure. The objective of this conceptual framework is to systematically organises the investigation about how MNCs examine a potential investment location, by dividing the host country's assessments into four distinct stages. The fundamental theoretical underpinning of this framework is providing an overview of the theoretical assumptions for the motivations of MNCs in undertaking FDI under the auspices of 'Institutional Theory', in particular, the 'New Institutional Economics' (NIE). Nevertheless, this tool is designed to assise MNCs when conducting examination of a host country as potential location, and as a guidance for any prospective host country to assess their position. The conceptual framework deploys both Transection Cost (TC) and Institutional Analysis and Development (IAD) as operationalize instrument to execute the theoretical underpinning fundamentals.

The Theoretical Underpinning

The overarching theoretical foundation for the conceptual framework is based on Institutional Theory, in particular, the NIE (Buckley & Casson, 1998; Dunning, 2001; North, 1990; Rugman & Verbeke, 1998). The reason behind choosing the NIE approach, as the overarching theoretical foundation, is because the NIE's ability to link institutional theory to transaction cost (Williamson, 1985, 1998)The transaction cost approach focuses on how the characteristics of a transaction affect the costs of economic activities - for this particular study, it is the cost of doing business and engaged in FDI for MNCs. The NIE, operating at macro and micro levels, covers both the institutional environment, or the *rules of the game*-macro), and the *arrangements of the institutions of governance* (Williamson, 2005). In this paper, the NIE is primarily used to examine the macro level, since this level affects the behaviour and performance of economic actors, that is, the MNCs, and the government.

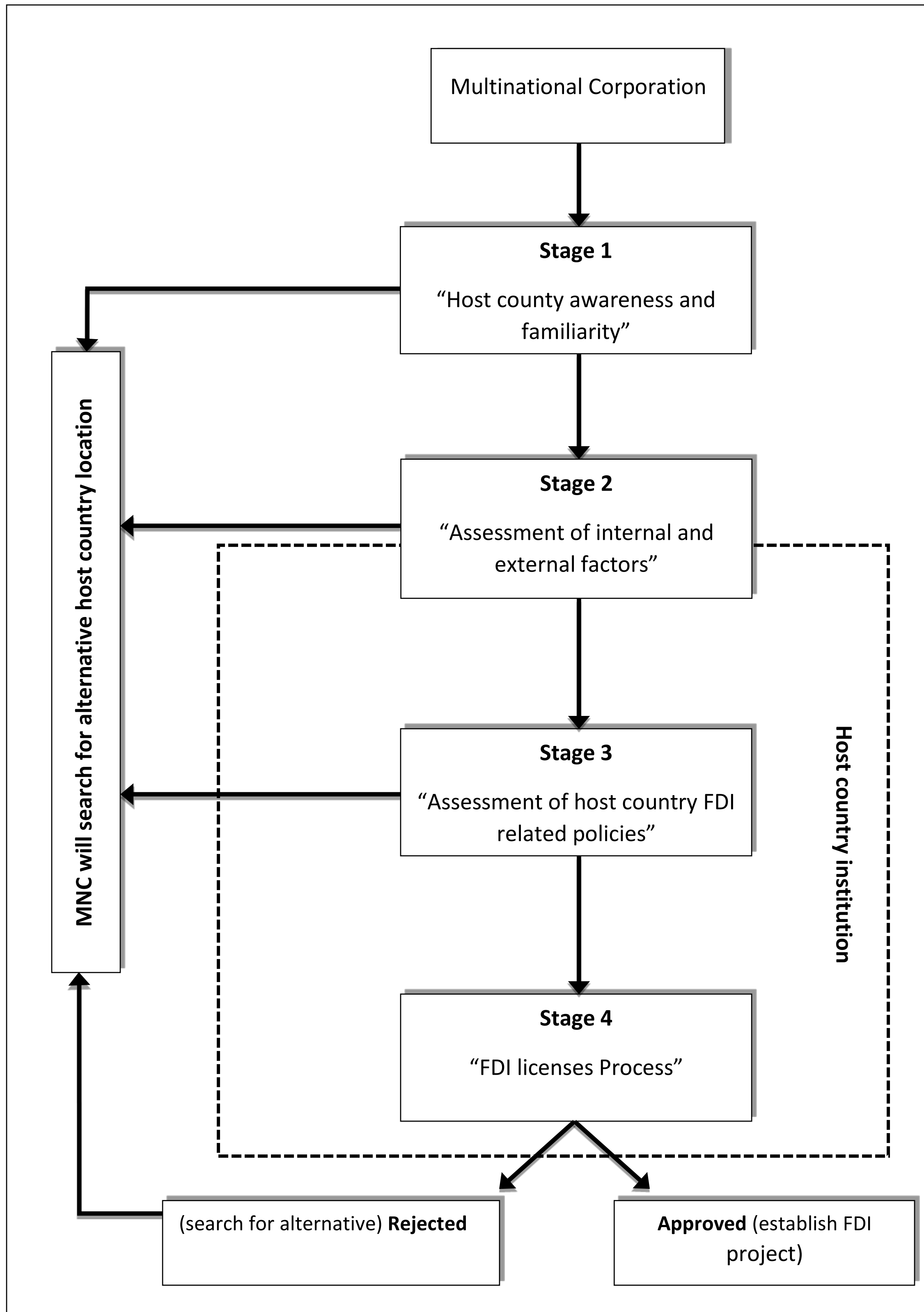
According to (K. E. Meyer, 2001) the transaction cost is an important element for MNCs during their search process for new FDI locations. The high level of uncertainty concerning specific investment locations (e.g., location advantages, rules and regulations, policies and other information) might increase the transaction cost (Williamson, 1998, 2005, 2014). Moreover, the transaction cost can play a significant role in cutting down the costs and uncertainty, by focusing on how institutions can play such important role in the context of FDI.

Conceptual Framework - Stages

The conceptual framework used in this paper consists of four stages, which are organised in a progressive order: 1) location consideration (covering aspects, such as, location awareness and familiarity of a MNC about a particular location), 2) examination of strategic factors, 3) examination of FDI related policies, and 4) examination of FDI licences process.

If, at any stage, MNCs find the result of their assessment unsatisfactory, the conceptual framework postulate that the MNC would then drop the location from its list of potential locations and search for an alternative investment location (see figure 1 below), which results in the host country losing the investment opportunity.

Figure 1 – Framework simulating MNC decision process when assessing a host country



Source: Adopted from Guisinger et al. 1985, and the author reflections

As illustrated in the figure above, the last stage of the conceptual framework postulates that if a MNC finds the assessment of the first three stages to be positive, then it would proceed to apply for a FDI permit in the potential host country. In such a case, the only reason that a FDI would not take place would be either that the FDI application is rejected by the government or that the MNC would withdraw the application voluntarily. The following sections explain the four different stages in the conceptual framework designed for this paper.

Stage one: MNCs' location consideration

This stage identifies familiarity and awareness as a factor for MNCs in choosing a host country. It also examines the level of awareness of MNC, because of its exposure to appropriate information regarding investment opportunities, FDI regulations, and FDI policies of a location (Dunning, 2001, 2004, 2006). The *'Familiarity'* in the Marriam-Webster dictionary is defined as *"having or showing realization, perception, or knowledge."*(Merriam-Webster, 2002) For the purpose of this paper, it refers to the MNCs' knowledge about the existence of a certain host country as a potential location for FDI. The '*Awareness'* is defined as a *"close acquaintance with something"* Here, it refers to MNCs' exposure to appropriate information regarding investment opportunities, including information about FDI regulations and policies. At this stage, it is postulated that familiarity with and awareness of a host country, and incentives that it offers to FDI projects, could be an important component in determining the level of inward FDI.

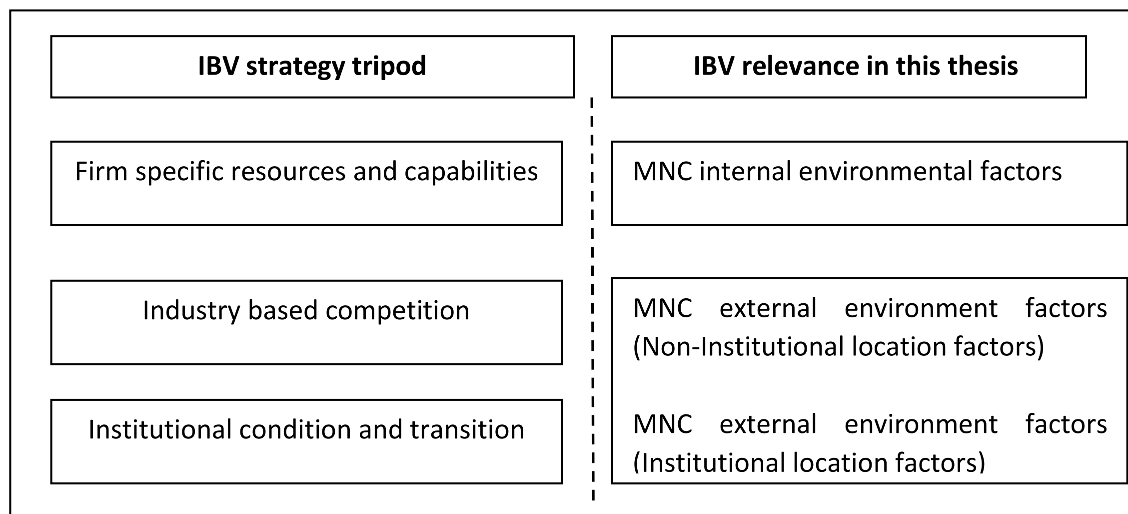
From a MNC's point of view, location familiarity and awareness is crucial during the initial search process, since decision-makers rarely engage in comprehensive location searches and prefer to consider a location which already is known to them (Eisenhardt, 1989). One of the reasons is that MNCs are generally exposed to a certain degree of uncertainty resulting from a lack of knowledge and awareness is the transaction costs (Williamson, 2010), when entering a foreign location. *"Most companies consider only a small range of potential investment locations. Many other countries are not even on their map"* (IFC, 1997, p. 19). This general rule is valid in cases where even limited familiarity and awareness of a potential location at the MNC exists(Cass, 2007). Consequently, if the condition of both location familiarity and awareness for a FDI destination is not satisfactory, MNCs are then prone to search for alternative locations.

However, if both location familiarity and awareness (about a potential host country for FDI) were sufficient, the MNC would then move to the next stage of the conceptual framework for additional assessment criteria. The lack of familiarity and awareness about a potential host country would result in the MNC to search for alternative locations.

Stage two: MNCs' Examination of strategic factors

Stage two focuses on MNCs' strategic assessments of the internal and external environment. The understanding of MNCs internal environment and the host country's location advantages must be presented in a systematic manner in order to avoid overlapping of MNCs' strategies and host country location advantages. Therefore, this stage of the conceptual framework adopts the particular Institution-Based View (IBV) as the theoretical foundation (M. Peng, 2002, 2003; M. Peng et al., 2008). This adoption was made mainly because IBV treats institutions as independent variables, focuses on the dynamic interaction between institutions and MNCs, and considers the strategic choice as the outcome of this interactions(M. Peng, 2003; M. Peng & Miles, 2009). Hence, IBV highlights institution's role in shaping MNCs' behaviour, strengthening this stage's argumentation in regards to the influence of institutions over MNCs decisions and their strategies (M. Peng, 2017, 2017; M. Peng & Miles, 2009). In order to better present MNCs' strategic assessments, when evaluating a new location, IBV component is modified to suite this paper, as illustrated in figure 10 below.

Figure 1 - IBV components renamed for this research



Source: adopted from (Peng, 2003, Peng *et al.*, 2009)

A. MNCs' examination of internal environment factors

MNCs' internal environment factors refer to a set of FDI motives of a MNC. MNCs' assessment of a potential location is generally based on how closely their FDI motives match what the new location can offer. For example, petroleum MNCs would generally search for a location, which possesses plenty of oil and gas reservoirs. A list of these internal environment motives or factors was first compiled by (Behrman, 1972) and later on extended by (Dunning, 1993). These motives or factors are market-seeking strategy, nature resource seeking strategy, efficiency seeking strategy and strategic asset seeking strategy (Dunning, 1977, 2006)

Other possible factors need to be taken into account when examining the factors that deter MNCs from considering a location for investment. These 'other' factors are: countering competition (Robock & Simmonds, 1989), and avoidance of collusion with a competitor (Hennart & Park, 1994). In such cases, a location would not be considered, if it is believed to be of a competitor's home country(Karnani & Wernerfelt, 1985; Wernerfelt, 1984), as MNCs would avoid collision with a stronger competitor (Tseng, 2005). Similarly, (Kogut & Chang, 1991) assert that a MNC would not consider a location, if the location has been penetrated by a strategic alliance, sister company, or subsidiary. Besides the internal factors influencing the choice of a location for a MNC's FDI, there are external factors that are equally important.

B. Examination of MNCs' external environment factors

External environment factors refer to a host country's location factors. In this paper, external environment factors are divided into two subcategories: a) non-institutional location factors, and b) institutional location factors. However, it is crucial to recall the discussion from the literature review chapter about the location factors. The fact is that there is a huge FDI literature available covering a large amount of location determinants that have been identified by researchers in IB studies, but the literature has yet to agree on the general terms for the classification of FDI location determinants.

1) MNC's external environment factors (Non-institutional location factors)

The non-institutional location factors refer to a certain favourable conditions, which provide the location with advantages in receiving FDI. The non-institutional location factors affect the costs and benefits of operating in a host location, therefore, influence MNCs' decisions. These favourable conditions are usually in the realm of economic, technological and infrastructural activities (Dunning, 2006), and generally lead to lower cost factors and higher profit margins (Galan et al., 2007). The cost factors comprise of elements, such as, labour costs (Tahir & Larimo, 2004), transportation costs (Buckley et al., 2007) , and cost of raw materials (Dunning, 2008). Parallel to the cost factors, as part of favourable conditions, are the market factors, entailing the size of the market in a location relating to the potential demand for a MNC's products and services (Pajunen, 2008). The third set of favourable location factors are the infrastructure and technological factors, such as, roads, ports, airports, rail-roads, IT infrastructure (M. Peng & Zhou, 2005), availability of skilled labour (Agarwal, 2002) as well as easy access to raw material from reliable local suppliers (Eckel, 2003).

There is also the geography of a location, which MNCs generally take into consideration during the location assessment process (Meyer et al., 2009). The MNCs, identifying a future foreign location for their investment, would also conduct risk assessment. In recent years, location risk, such as, country risk, sovereign risk, and political risk has been given more attention by MNCs (Luo, 2009). This is particularly true in case of the developing countries (Busse & Hefeker, 2007). The last location factors include: the local culture, and social factors (Kogut & Yang, 2016)These favourable conditions include cost factors (such as, labour costs, transportation and cost of raw materials), market factors (entailing the size of the existing demand for an MNCs' products and services), Infrastructure and technological factors and geographical factors.

2) MNCs' external environment factors (Institutional location factors)

The institutional factors, such as, protection of intellectual property, legal system, bureaucracy and corruption (Ali et al., 2010; L. Peng et al., 2020) are a mixture of formal and informal institutional factors that affect the rules of the game (Sánchez-Martín et al., 2014). The effectiveness of such factors are indicative of a host country's institutional health (Tallman et al., 2018). The respective

rules of the game affect the costs and benefits of doing business in a host country, and consequently influence MNCs' FDI decision(s). Therefore, if the rules of the game were thought to lead to higher transaction costs relative to its benefits, this would deter MNCs from choosing that location.

The MNCs pay a particular attention to these factors in the developing countries, as suggested by the recent studies. For instance, weak intellectual property protection and corruption, which increases uncertainty and results in higher costs (Cuervo-Cazurra, 2016), would deter MNCs to conduct FDI. When a MNC examines a new location for potential FDI, the decisions made are based on strategic assessments of its internal environmental factors (the motives of a MNC for FDI) matching them with a location's specific advantages on one hand; and an assessment of the external environmental factors of both non-institutional and institutional location factors, on the other. Once a MNC is satisfied with the outcome of these two sets of assessments, it would then move to the examination of FDI policies (the next stage of the conceptual framework, see figure 11 - Flowchart of the stage two).

Table 1- Key Non-institutional location factors

Non-Institutional location factors	**Components of the Non-Institutional location factors**
Cost factors	- Transportation and logistics costs - Cost of raw materials, energy, and water
Market factors	- Size of location market - Growing demand in the location market
Efficiency factors	- Infrastructures in the selected location - Skilled Labour in the selected location - Technologically advanced (e.g., IT, Telecommunications)
Geographical factor	- Geographical location of the selected location
Social and cultural amenities	- Standard of living in the selected location - Public services in the selected location - Cultural affinity
Location Risk factor	- Country risk of in the selected location - Political risk in in the selected location

Source: Dunning 2006 and Galan el al 2007

Stage Three: MNCs' Examination of FDI Policies

This stage of the conceptual framework, as the final stage of MNCs location assessments, focuses on their examination of a host country's attractiveness for FDI policies. This plays an important influencing role for MNCs' decisions regarding whether to opt for FDI or not (Dunning, 2008; Moosa, 2019). The FDI policies are designed to strengthen a country's investment climate and competitiveness in attracting MNCs play a vital role in attracting MNCs to a location. The respective policies are generally geared towards the removal of restrictions on the operations of foreign MNCs in a host country in tandem with reducing cost factors for them (Gastanaga *et al.*, 1998, Globerman and Shapiro, 1999). These policies are designed to strengthen a country's investment climate and competitiveness in attracting MNCs (Jensen & Behmer, 2018), which are based on the location advantages, and competitiveness parameters (Enderwick, 2017; Parboteeah et al., 2008) There is a huge existing literature available, which covers a large amount of FDI related policies. However, in this paper, the focus will be on policies that result in attracting foreign investors and promoting host country's economic attractiveness.

Stage four: MNCs' examination of FDI licensing procedure

This final stage of the conceptual framework investigates the role of a host country's institutions on the FDI licensing process. While the majority of countries seek to attract inward FDI have simplified their FDI licensing process (e.g., license approval), others have put a complex procedure in place toward FDI licensing process (Peschka & Emery, 2011) . The poor performance of some countries for inward FDI flows is largely attributed to the scope of government intervention (Kobeissi, 2005, 2009). This is exerted through country's institutions by creating significant entry barriers in the form of excessive entry approval procedures, and bureaucratic process in order to limit, or reject foreign MNC to conduct business in that country (Morisset & Olivier, 2002). This is mainly due to concerns about potential negative effects of MNCs, such as, crowding out local products and firms with harmful socio-cultural effects, suppressing domestic entrepreneurial development, and strong influence on economic affairs and decision making, with possible negative effects on industrial development (WIR, 2003). As an example, it takes 60 days to register a business in West Asian countries compared to just about two weeks in OECD countries (Habib & Zurawicki, 2002). Morisset and Neso assert that - *"barriers to entry are a substitute for the*

government's unwillingness or inability to regulate enterprise operations" (Morisset & Lumenga-Neso, 2002, p. 120).

It is widely recognised that institutions have a critical role in the performance of organisations. While recent studies have focused on formal institutions and their impact FDI flows (Li and Filer, 2007, Pajunen, 2008, Ali *et al.*, 2010), the role of informal institutions in influencing FDI has received limited attention in the literature. There has been indications that informal institutions can be both performance enhancing, or performance damaging in attracting FDI (Zenger *et al.*, 2002). The informal institutions are normally a part of the culture and norms of a society (Lauth, 2000), and rooted in the beliefs of individuals in small "face-to-face communities" (Raiser, 1997).

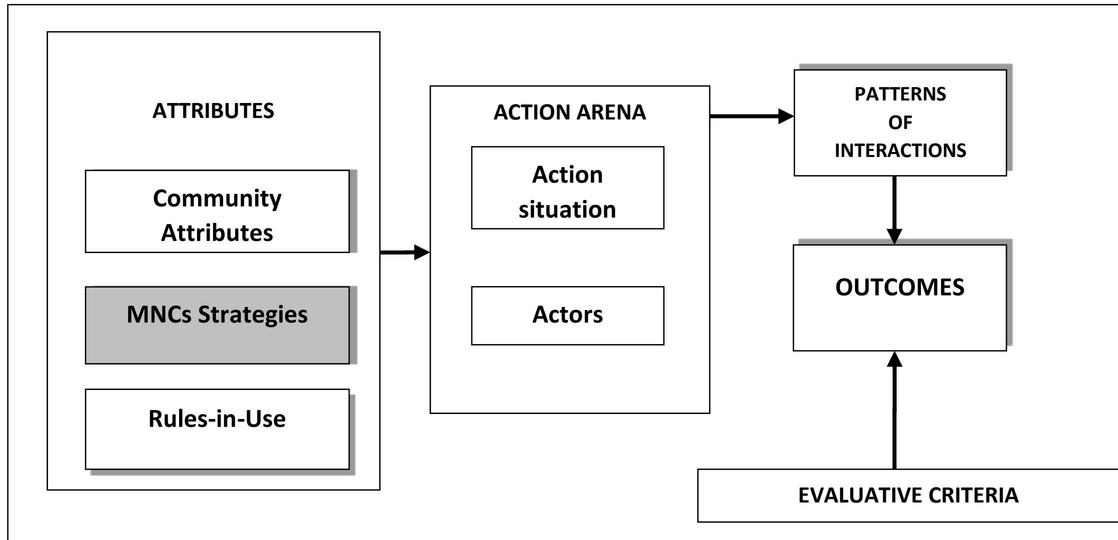
The high rejection rate of FDI applications is linked to the host country' institutional environment (Kostova, 1997; Kostova et al., 2008; Kostova & Roth, 2002), interfering and influencing the process of FDI license decision. Thus, Due to the complexity of this type of investigation, there is a need for a systematic approach to enable the analysis of possible influence of both formal and informal institutions on the FDI licensing policy. Proposed by Bushouse (2011), the Institutional Analysis and Development (IAD) framework is a systematic approach that considers both formal and informal institutions, when diagnosis and analysis policy process is used. (Ostram, 2007; Ostrom, 2005; Polski & Ostrom, 1999). The IAD framework is best viewed as a systematic approach for organising policy analysis activities that are compatible with a wide variety of more specialised analysis techniques used in the social sciences (Ostrom, 2011). The IAD does not replace other methods of analysis rather complement them, as it synthesises the work of multiple participants, including those who are directly involved in the policymaking, and takes an interest in the policy outcomes. The IAD framework incorporates a number of theories, which explains individual behaviour within the institutional context. It focuses on five main components: 1) the decision maker, 2) the community affected by the decisions made, 3) the goods and services available to individuals whom seek to produce, provide or consume, 4) the institutional arrangements guiding individual decisions, and 5) the decision in the context in which individuals make choices (Ostrom, 2005).

The IAD framework, as a diagnostic tool, facilitates a better understanding of complex social situations for policy analysts by breaking the phenomenon down into manageable sets of practical activities (Ostrom, 2011) . The IAD framework was selected as the core analytical framework for several reasons, which have been discussed in chapter two.

Within the action arena of the IAD framework, both participants and action situation interact as they are affected by exogenous variables (physical and material conditions as well as attributes of the community and rules-in-use), producing outcomes. The criterion is used to judge the performance of the policy process by examining the outcomes. Based on the IAD framework components, an additional exogenous variable was added to the original IAD framework, labelled 'MNCs strategies', referring to the entry mode choice accessible to MNCs. This particular variable can have an influence on the action situation, as the choice of entry mode is particularly important to MNCs' decisions of entry mode by moderating the costs of alternative entry mode(Alawadhi, 2014). Such additional variable is important as formal rules can allow MNCs' range of entry modes choices, informal rules and the 'rule of the game' can also affects these choices (Meyer et al., 2009). This means that a trade-off between the optimal entry mode in lieu of the additional transaction costs imposed by the informal institutions on MNCs have to considered. For example, if a host country increases restrictions on foreign MNCs entry mode of FDI institutions (both formal and informal), this will increase the MNC's need for a local agent, forcing the MNC into a joint venture in order to gain access to the market through their local partner (M. Peng, 2003, 2017). Under the additional variable of MNCs strategies in the examination of the role of the MNCs' strategies starts with considering alternative FDI entry mode within the action arena. The MNCs' strategic context is then examined under a dynamic perspective of FDI entry options and distributed among decision makers with the view of understanding the economic interests that drive participants' decisions within a particular set of rules-in-use. In the next step, the examination of rules can inform the analyst about the way the current set of rules-in-use affect the power distribution among the actors, and whether the institutional change can lead to outcomes that are more favourable. MNCs' strategies are linked to the rules-in-use not only because they affect institutions, but also because it’s essential for this paper to understand why a MNC decide to choose other entry modes like licensing (Shane, 1994) or strategic alliance over FDI (Harzing, 2003;Harzing & Pudelko, 2016). The examination of rules in use informs the analyst as to whether or not MNC’s decision is

dependent on the restrictions placed on the entry mode. This in turn would explain why some countries receive lower FDI inflow than others, despite their competitiveness and locational advantages, providing the rationale for the additional exogenous variable (MNCs strategies) to the IAD framework.

Figure 1 - Revised IAD Framework adopted for this paper



Source: adopted from Ostrom (1994, 2005)

This revision of the IAD framework paves the way to further examine whether MNCs strategies do affect the decision making process on regulating the entry choice available for MNCs. Based on the above reasoning, the implication of the revised IAD framework in this paper postulate that the host country's institutions' (both formal an informal) interference does indeed influence the process of issuing FDI licensing approvals. With a protectionist agenda, then, it would lead to limiting and reducing inward FDI flow.

Conclusion

This paper tries to establish an assessment in the context of conceptual framework to be deployed in explaining why some countries receive lower FDI inflow than others despite their competitiveness and advantages. This tool would more suitable for developing countries in general and the small economics in particular.

The aim of this conceptual framework is to systematically organises the investigation about how MNCs examine a potential investment location, by dividing the host country's assessments into four distinct stages. The fundamental theoretical underpinning of this framework is new institutional economics.

The conceptual framework used in this paper consists of four stages, which are organised in a progressive order. Hence, If at any stage, MNCs find the result of their assessment unsatisfactory, the conceptual framework postulate that the MNC would then drop the location from its list of potential locations and search for an alternative investment location, which results in the host country losing the investment opportunity.

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